No. 84- ____

84-646

IN THE

Supreme Court of the United States

OCTOBER TERM, 1984

PEAT, MARWICK, MITCHELL & CO.,

Petitioner,

—against—

DAVID A. and SYLVIA S. LIPTON,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

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October 22, 1984

86 pp

QUESTION PRESENTED

Whether a complaint seeking damages for alleged violations of § 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5 states a claim upon which relief can be granted when plaintiffs admit they did not read or rely upon the allegedly misleading documents and the complaint, asserting a "fraud on the market" theory, alleges merely that plaintiff purchased securities relying "on the integrity of the market prices" of those securities and that because of the misrepresentations and omissions alleged "the market prices of . . . [the] securities were artificially inflated" and there is no allegation that the securities would not have been marketed at all but for the misrepresentations and omissions complained of?

This question is that which was certified by the district court pursuant to 28 U.S.C. § 1292(b) and answered in the affirmative by the court of appeals. It presents the issues which the Court granted certiorari to consider but was denied the opportunity to do so when the action was dismissed by the appellee. *Panzirer* v. *Wolf*, 663 F.2d 365 (2d Cir. 1981), *cert. granted sub nom. Price Waterhouse* v. *Panzirer*, 458 U.S. 1105, *vacated as moot*, 459 U.S. 1027 (1982).

Last term, the Court observed that the independent auditor performs a very "special function" in our society and that central to the auditor's function is his "total independence" from his client. *United States* v. *Arthur Young & Co.*, 104 S. Ct. 1495, 1503 (1984). A corollary to the "fraud on the market" theory is the impermissible implication of a "presumption" of *non*-independence which is antithetical to the very existence of the accounting profession. The question presented subsumes within it the question:

Whether, even if that question is answered generally in the affirmative as to the issuer and its management, such

a complaint states a claim upon which relief can be granted against the issuer's independent auditor when the only alleged involvement of the auditor is the performance of specified auditing services and the plaintiff was wholly unaware of the auditor's existence, much less his opinion concerning the issuer's financial statement?

PARTIES BELOW

The parties participating below were Peat, Marwick, Mitchell & Co. ("PMM"), Documation, Inc. ("Documation"), S. Ray Halbert, Richard J. Testa, Robert S. Ames, John H. Holcomb, Jr., James F. Morgan and Textron Inc., appellants, and David A. and Sylvia S. Lipton, appellees.

Pursuant to Rule 21.1(b) of the Rules of the Court, the Court is informed that petitioner PMM, a partnership, is a national firm of certified public accountants.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases PAGE

Congressional Documents

Law Reviews

PAGE

Rules and Regulations

Statutes

Treatises

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Opinions Below

The decision of the United States Court of Appeals for the Eleventh Circuit is reported at 734 F.2d 740 and is set forth in the appendix to this petition commencing at p. 1a. The petition for rehearing and suggestion for rehearing en banc was denied without opinion. (pp. 32a-33a) The decision of the United States District Court for the Middle District of Florida (Kovachevich, J.), affirmed by the Eleventh Circuit, is reported at [1982] CCH Fed. Sec. L. Rep. ¶ 98,788, and is set forth in the appendix commencing at p. 15a. The Eleventh Circuit had agreed to hear the appeal following certification of the question presented for review here as a controlling question of law pursuant to 28 U.S.C. § 1292(b) (1982). (pp. 24a-29a)

Jurisdiction

The decision of the court of appeals denying rehearing and rehearing en banc of its June 18, 1984 decision was filed on July 23, 1984. Jurisdiction is conferred on the Court by 28 U.S.C. § 1254(1) (1982).

Statutory Provisions

Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. § 78j(b) (1982), reads as follows:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * *
>
> "(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Pursuant to the authority granted by § 10(b), the Securities and Exchange Commission in 1942 promulgated Rule 10b-5, now 17 C.F.R. § 240.10b-5 (1984), which reads as follows:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> "(1) To employ any device, scheme, or artifice to defraud

"(2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

"in connection with the purchase or sale of any security."

Statement of the Case

Plaintiffs' amended complaint is set forth in the appendix commencing at p. 34a. The defendants moved to dismiss the amended complaint. On August 18, 1982, the district court denied defendants' motions to dismiss the § 10(b) counts while granting PMM's motion to dismiss pendent common law claims for negligence. (pp. 15a-23a)

The district court, on December 1, 1982, granted PMM's motion for certification of the question presented here. (pp. 24a-28a)

On January 25, 1983, the Eleventh Circuit granted defendants' petition for leave to appeal. (p. 29a)

On June 18, 1984 (following oral argument on March 12, 1984), a Panel of the Eleventh Circuit rendered the decision (pp. 1a-14a), which is the subject of this petition. Petitioner's petition for rehearing and suggestion for rehearing en banc of that decision was denied on July 23, 1984. (pp. 32a-33a)

Because of the procedural posture of this action, there are no issues of fact. The allegations of plaintiffs' amended complaint are taken as true. *Conley* v. *Gibson*, 355 U.S. 41 (1957). Thus, the absence of factual disputes makes this an even more appropriate vehicle for resolution of the question presented than *Panzirer* v. *Wolf*, 663 F.2d 365 (2d Cir. 1981), *cert. granted sub nom. Price Waterhouse* v. *Panzirer*, 458 U.S. 1105, *vacated as moot*, 459 U.S. 1027 (1982).

The amended complaint (pp. 34a-61a) alleges that subject matter jurisdiction is found in § 27 of the 1934 Act, 15 U.S.C. § 78aa (1982), and in the principle of pendent jurisdiction. (pp. 34a-35a)

Count I of the four-count amended complaint seeks to state a claim against Documation, the issuer, and its management—but not PMM—for a broad course of conduct alleged to be violations of § 10(b) and Rule 10b-5. (pp. 40a-55a) Count II seeks to state a claim against PMM alone for alleged violations of § 10(b) and Rule 10b-5 in connection with two audit reports concerning Documation's financial statements for fiscal 1977 and fiscal 1978. (pp. 55a-58a) Counts III and IV seek to state claims against all defendants for common law fraud and deceit and for common law negligence or gross negligence. (pp. 59a-60a) Since diversity is absent, there is no federal subject matter jurisdiction for these counts, apart from the federal claims in Counts I and II.

The amended complaint alleges in Count I that all defendants other than PMM participated in a "common course of conduct" which consisted of the preparation and issuance of various documents relating to Documation, including annual reports, prospectuses, quarterly reports and press releases, which allegedly contained misrepresentations of material facts concerning Documation's revenue recognition policies and accounting for inventory. As the amended complaint itself recognizes by its separate Count I against the defendants other than PMM and its Count II against PMM, which relates solely to its audit reports, there are significant differences among the defendants.

Counsel for the named plaintiffs told the court of appeals that "[p]aragraphs 49 and 50 of the [amended] Complaint . . . contain the requisite 'fraud on the market' allegations. . . ." Those paragraphs read as follows:

> "49. As a result of the dissemination of false and misleading information and the failure to disclose material facts, as set forth above, the market prices of Documation securities were artificially inflated during the class

period. In ignorance of the false and misleading nature of the representations described above and in the absence of the material information which the defendants failed to disclose, as described above, plaintiffs and other members of the class relied, to their damage, on the integrity of the market prices of Documation securities during the class period in purchasing their Documation securities. At the time of the purchases by plaintiffs and the class of said securities, the fair market value of said securities was substantially less than the prices paid by them.

"50. The prices of Documation securities declined sharply upon the public disclosure of the facts which had been misrepresented or concealed as alleged herein. Plaintiffs and other members of the class have suffered substantial damages as a result of their purchases of Documation stock at prices which were inflated by the wrongful conduct of defendants." (p. 55a)

In introducing Count II, plaintiffs chose not to reallege paragraph 49 as part of the allegations of Count II of the amended complaint against PMM. (p. 55a)

As to the independent auditor, plaintiffs allege that:

"Defendant Peat, Marwick, Mitchell & Co. ('PMM') is a firm of certified public accountants which performed certain accounting and auditing services for Documation . . . ." (p. 38a)

and that

"PMM knew or recklessly disregarded" certain matters "alleged" in the complaint, and failed to use "due professional care," make "a proper study" or gather "sufficient competent evidential matter" during its audit. (p. 57a)

There is no allegation that PMM was part of the common course of conduct alleged in Count I.[1]

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1 In point of fact, the amended complaint alleges that the "fraud" came to light when PMM disagreed with Documation regarding the "recording of revenues." (Amend. Compl. ¶ 41; p. 52a)

REASONS FOR GRANTING THE WRIT

The Question Presented Raises an Unresolved Issue of Fundamental Importance

It has been estimated that Rule 10b-5 actions account for about one-third of all cases, public and private, brought under SEC statutes. 1 A. Bromberg & L. Lowenfels, *Securities Fraud and Commodities Fraud* § 2.5(6) (1983). Since the private cause of action created under Rule 10b-5 is of judicial origin, *see Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975), its elements and bounds are uncertain—a fact which vastly affects how discovery and trial in such actions are conducted. A crucial uncertainty is whether actual reliance upon the alleged misrepresentation or omission is an element of the action.

> "One example of the uncertainty which surrounds the rule is the debate over the extent to which recovery is limited to plaintiffs who have actually relied on a misrepresentation or omission. Although courts have consistently declared in dicta that reliance is a distinct element of a 10b-5 action, application of this principle has become subject to many modifications and exceptions. The most important of these modifications have been the redefinition of reliance and the use of a presumption of reliance in certain situations."

Note, *Shores v. Sklar: The Fifth Circuit's New Version of the Fraud on the Market Theory*, 47 Albany L. Rev. 597, 602 (1983) (footnotes omitted).

As the court of appeals recognized, "the Supreme Court has yet to address the issue." (5a)

The "fraud on the market" theory assumes the validity of what is termed by economists as the "efficient capital market hypothesis"—*i.e.*, that at all times the market price of a security reflects the market's appreciation of all significant

factors concerning the issues of the security, its line of business and all the macro and micro-economic forces that affect perceptions of the economy and of the stock market. *See* Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C. L. Rev. 435 (1984); Rapp, *Rule 10b-5 and "Fraud-On-The-Market,"* 39 Wash. & Lee L. Rev. 861 (1982); Note, *The Fraud-On-The-Market Theory*, 95 Harv. L. Rev. 1143 (1982).

As recently recognized in Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549-50 (1984):

> "Of all recent developments in financial economics, the efficient capital market hypothesis ("ECMH") has achieved the widest acceptance by the legal culture. . . . Yet the legal culture's remarkably rapid and broad acceptance of an economic concept that did not exist twenty years ago is not matched by an equivalent degree of understanding." (Footnotes omitted)

Whereas the efficient capital market hypothesis depends for its acceptance very much on the specific market being studied, some federal courts have seized upon it as a veritable cure-all for the difficulties encountered in many nationwide class actions. The theory was first judicially utilized in the context of a motion for class action certification to bypass the "commonality" requirement of Fed. R. Civ. P. 23. *See Blackie* v. *Barrack*, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976):

> "Indeed, we could, in the exercise of our Article III jurisdiction, transform the 10b-5 suit from its present private compensatory mold by predicating liability to purchasers solely on the materiality of a misrepresentation (*i.e.*, economic damage) regardless of transactional causation, without implicating the Enabling Act limitation." (524 F.2d at 908 n.24)

Precisely that "transformation" has now occurred, as in this case. Application of the "fraud on the market" theory has now spilled over into the Rule 12(b)(6) context so as to fundamen-

tally alter the substantive elements of the 10b-5 cause of action. An accommodation to facilitate application of Rule 23 has greatly modified substantive rights. *But see* 28 U.S.C. § 2072 (1982) ("[s]uch rules shall not abridge, enlarge or modify any substantive right").

It is important for the Court to consider this issue now, otherwise litigations already instituted will be expanded by substantial testimony by economists as to whether any particular statement had a significant impact upon market movement. This theory will also lead to a lowering of the threshold showing for security fraud actions, thus increasing the number of actions commenced and the *in terrorem* value of those that pass the pleading stage of the litigation. This can only lead to a waste of judicial and litigant resources.

Conflict With Relevant Legislative History

The legislative history of § 18 of the 1934 Act, 15 U.S.C. § 78r (1982), an express remedy for fraud violations, is relevant to the proper understanding of § 10(b), which is an implied remedy. *See* the court of appeals' opinion below at p. 13a n.12.[2] The initial version of the provision which later became § 18 required only that the plaintiff be a person "who shall have purchased or sold a security *the price of which may have been affected by such statement. . . .*" S. 2693, 73d Cong., 2d Sess. § 17(a) (1934) (emphasis supplied). (There is, of course, no difference between a price "affected by" a misleading statement and a price artificially inflated, or deflated, by a misleading statement.) That version was criticized in the hearings concerning the 1934 Act because it permitted recovery of damages by persons "who ha[d] not relied upon the inaccurate or misleading statement" and by those who

2 The court of appeals paid lip service to the relevance of the legislative history, but it did not attempt to reconcile such history with the conclusions it reached.

"trade recklessly" and by "unscrupulous traders" who were not misled by the statements later alleged to be false.[3]

Because of that criticism, the bill was redrafted and the requirement of purchase or sale "in reliance upon such statement" was added. As explained by Representative Sam Rayburn, then Chairman of the Committee on Interstate and Foreign Commerce:

> "The first provision of the bill as originally written was very much challenged on the ground that reliance should be required. This objection has been met." (78 Cong. Rec. at 7701 (April 30, 1934)).

See also S. Report No. 792, 73d Cong. 2d Sess. 13 (1934) ("[T]he burden is on the plaintiff to show . . . that he relied [on the misleading statement] to his damage."), quoted in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 206 (1976).

The "fraud on the market" theory conflicts with this legislative history and in advocating this theory, the court of appeals ignored the Court's admonition in *Touche Ross & Co.* v. *Redington*, 442 U.S. 560, 578 (1979), that "[t]he ultimate question is one of congressional intent, not one of whether this Court thinks that it can improve upon the statutory scheme that Congress enacted into law."

The theory also places directly in issue a point several times raised but never decided by the Court—whether it is permissible to imply a private right of action (§ 10(b)) which effectively nullifies an express remedy contained within the *same* statute (§ 18). *See Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 210

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3 *Stock Exchange Practices: Hearings on S. Res. 84, S. Res. 56 and S. Res. 97 Before Sen. Comm. on Banking and Currency*, 73d Cong., 2d Sess. at 6638, 7084 (1934) ("1934 Senate Hearings"); *Stock Exchange Regulation: Hearing on H.R. 7852 and 8720 Before House Comm. on Interstate and Foreign Commerce*, 73d Cong. 2d Sess. at 226, 656 (1934) ("1934 House Hearings"). *See also* 1934 Senate Hearings at 6939, 7186, 7567-68; 1934 House Hearings at 262, 489.

(1976); *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 383-84 (1983).

In *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462 (1977), the Court stated with respect to a 10b-5 action:

> "[T]he 'fundamental purpose' of the [1934] Act [is] implementing a 'philosophy of full disclosure'; once full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the statute." (430 U.S. at 477-78) (citing *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375 (1970)).

In holding that plaintiffs who admittedly did not see, much less read and rely upon, any of the allegedly offending documents nonetheless stated a cause of action, the court of appeals rendered inconsequential the method employed by Congress to implement the "fundamental purpose" of full disclosure. *See Shores* v. *Sklar*, 647 F.2d 462, 483 (5th Cir. 1981) (en banc; 12 to 10 decision) (Randall, J. dissenting), *cert. denied*, 459 U.S. 1102 (1983):

> "[F]ederal securities laws are intended to put investors into a position from which they can help themselves by relying upon disclosures that others are obligated to make. . . . If we say that a plaintiff may recover in some circumstances even though he did not read and rely on the defendants' public disclosures, then no one need pay attention to those disclosures and the method employed by Congress to achieve the objective of the 1934 Act is defeated."

Disregard of the Fundamental Tort Law Requirement of Reliance

Actions sounding in tort require that there be a reasonably direct and close causal connection—proximate cause—between the defendant's wrongdoing and the plaintiff's injury. In an action for deceit the injury lies in the plaintiff's response to the

defendant's deception, and there must be a causal connection between the two.[4]

Section 10(b) forbids the use of any manipulative device or contrivance "in connection with the purchase or sále of any security." The three subdivisions of Rule 10b-5 which implement § 10(b) are, of course, also subject to the limitation that the proscribed conduct be "in connection with the purchase or sale of any security."

The "in connection with" limitation or requirement was the basis for the holding of *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975), that § 10(b) and Rule 10b-5 apply only to an actual purchase or sale induced by the defendant's wrongdoing, not to a decision to refrain from buying or selling although that decision was, like the decision to buy or sell, induced by a violation of § 10(b) on the part of the defendant. *Blue Chip Stamps* placed one limitation upon the conceivable universe of potential § 10(b) suitors. Another limitation, also derived from the required "in connection with" nexus between the plaintiff's decision to buy or sell and the defendant's violation, is at issue here.[5]

Reliance provides the necessary causal connection. As stated by the Court of Appeals for the Second Circuit: "The element of reliance serves to restrict the potentially limitless thrust of rule 10b-5 to those situations in which there exists causation in fact between the defendant's act and the plaintiff's injury." *Wilson* v. *Comtech Telecommunications Corp.*, 648 F.2d 88, 92 (2d Cir. 1981) (citations and footnote omitted). *See also*

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4 *See, e.g.*, W. Prosser, *Handbook of the Law of Torts* § 108, at 714 (4th ed. 1971) ("The false representation must have played a material and substantial part in leading the plaintiff to adopt his particular course. . . .").

5 It is noteworthy that in *Blue Chip Stamps*, the Court presumed that the plaintiff read the prospectus and paid some attention to it. *See* 421 U.S. at 746.

Zobrist v. *Coal-X, Inc.*, 708 F.2d 1511, 1516 (10th Cir. 1983); *Vervaecke* v. *Chiles, Heider & Co.*, 578 F.2d 713 (8th Cir. 1978); *Dupuy* v. *Dupuy*, 551 F.2d 1005 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); *Holdsworth* v. *Strong*, 545 F.2d 687 (10th Cir. 1976) (en banc), *cert. denied*, 430 U.S. 955 (1977); *Landy* v. *FDIC*, 486 F.2d 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

Adoption of the "fraud on the market" theory by the court of appeals gave a 10,000 member plaintiff class an *in terrorem* claim where none of the named plaintiffs is alleged even to have read much less relied upon the alleged misleading document.

Judicial Underwriting of Investors' Insurance

In *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975), the Court feared that broadening the class of 10b-5 plaintiffs would do "more harm than good" because it could expose defendants to " 'liability in an indeterminate amount for an indeterminate time to an indeterminate class.' " 421 U.S. at 747-48. *Accord*, *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 214-16 n.23 (1976).

All twenty-two judges participating in the en banc decision in *Shores* v. *Sklar*, 647 F.2d 462 (5th Cir. 1981) (en banc; 12 to 10 decision), *cert. denied*, 459 U.S. 1102 (1983), agreed that Rule 10b-5 should not be interpreted to "establish a scheme of investors' insurance" (647 F.2d at 469 n.5) (majority); "the securities laws enacted by Congress in the 1930s were not intended to create a scheme of investors' insurance" (647 F.2d at 482) (dissent). *See also Dirks* v. *SEC*, 103 S. Ct. 3255, 3267 n.27 (1983) ("[A]s market values fluctuate and investors act on inevitably incomplete or incorrect information, there always are winners and losers; but those who have 'lost' have not necessarily been defrauded."); *List* v. *Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965). The decision here, however, established just such a scheme of investor insurance.

The court of appeals' decision, if it is allowed to stand, would have the following result in a class action: Every investor who purchased in a class period would be able to recover against any person whose misstatement arguably had an impact upon price without any consideration of whether that particular investor paid any attention to the particular misstatement complained of, provided only that he was able to prove the existence of the misstatement. That is a basic change in Rule 10b-5 actions, which heretofore required the existence of some causal connection between the misstatement and the purchase decision. This change will result in transforming 10(b) actions into the "merely private enforcement mechanisms" (734 F.2d at 742), that the Eleventh Circuit inveighed against. Inexorably, application of the court of appeal's decision will result in the commencement of more securities suits and a significant increase in exposure in the suits that are brought. This result is especially troubling for an institutional defendant, such as an accounting firm like PMM, for whom such a lawsuit is not a one-time phenomenon.

The court of appeals disguised the insurance scheme it was creating, by stating that reliance was only a presumption that could be rebutted in specified ways. Examination of the rebuttal alternatives, however, proves them meaningless. The first—that the defendant can prove his misstatement did not have a material impact upon price—does nothing more than restate the requirement of materiality, an element of *plantiff's* prima facie case. Of course, a defendant is not liable for an immaterial misstatement; casting this concept in terms of a rebuttal gives no substance to the rebuttal as a meaningful limitation upon the prosecution.

The second alternative—that the defendant may prove the plaintiff knew of the misstatement or would have bought anyway—is illusory. In the context of a large-scale developed market, it will be nigh impossible to identify the plaintiff who will admit to knowing of the alleged misstatement. Considerable time and energy would be spent to ferret out those who simply do not care. While it is conceivable that the rebuttal

may become a factor in a rare circumstance, the rebuttal aspect does not change the basic nature of the insurance scheme adopted by the court of appeals.

The impact of an investor insurance scheme weighs particularly hard upon so-called institutional defendants, such as accountants. They are the most peripheral to the alleged scheme and earn only a fee for professional services, yet bear the biggest monetary risk because of their "deep-pocket" status—a risk intensified by the growing willingness of companies to file in bankruptcy and thus avoid their own legal liabilities. For those reasons, as well as the sheer breadth of their practice, the peripheral defendants are sued whenever one of their clients experiences economic difficulties. Their exposure is a multiple of the number of lawsuits brought against them and it is no secret that professional insurance has become more difficult and more expensive to obtain. The decision below threatens to increase both the number of suits and the individual exposure on each one. It is hardly unreasonable to ask instead that the plaintiffs in such lawsuits at least allege that they relied in some manner on the work done by tangential defendants. Whatever the merits of the fraud on the market theory as to principal defendants, thorough consideration should be given to its effect on tangential defendants, especially where as here the tangential defendant is a professional not accused of being part of a scheme.

The independent auditor performs a very "special function" in our society. *United States* v. *Arthur Young & Co.*, 104. S. Ct. 1495, 1503 (1984). In recognition of this, in the drafting of § 18 of the 1934 Act,[6] Congress expressly protected the accounting profession from liability for honest errors in judgment. *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 211 n.31 (1976) (citing Senate and House hearings). This is consistent with the limited liability of experts such as accountants under the 1933 Act. *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 381 (1983).

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6 The Panel decision in this action recognized the relevance of the legislative history of § 18 "to an understanding of Section 10(b)." (p. 13a n.12)

Where, as here, there is no allegation of *non*-independence and the auditor's only involvement is the rendering of professional accounting and auditing services resulting in the auditor's report—of which the plaintiffs were wholly unaware—there is no permissible basis in law for the assertion of a "fraud on the market" theory against the independent public accountant.

Because of the importance of the issue, the Court should take the opportunity presented by this case to reject the so called fraud on the market theory, or, at a minimum, to reject its application to independent public accountants.

CONCLUSION

For the reasons set forth above, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX

CONTENTS

Opinion of the United States Court of Appeals for the Eleventh Circuit

UNITED STATES COURT OF APPEALS
ELEVENTH CIRCUIT

No. 83-3126

June 18, 1984

DAVID A. LIPTON and SYLVIA S. LIPTON,

Plaintiffs-Appellees,

—v.—

DOCUMATION, INC., et al.,

Defendants-Appellants.

Appeal from the United States District Court
for the Middle District of Florida

(D.C. No. 80-555)

Before:

KRAVITCH and ANDERSON, *Circuit Judges*,
and TUTTLE, *Senior Circuit Judge*.

KRAVITCH, *Circuit Judge*:

The plaintiffs brought this proposed class action on behalf of themselves and other purchasers of Documation, Inc. se-

curities, alleging violations of § 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission rule 10b-5.[1] As the basis of their complaint, the plaintiffs rely on what has commonly become known as the "fraud on the market" theory. Specifically, they allege that the defendants disseminated into the marketplace financial reports and statements that falsely claimed that Documation had substantial earnings and revenue, when, in fact, the defendants knew that the company had suffered a significant net loss. The plaintiffs further allege that although they did not rely directly on these misleading documents, the documents caused the market price of Documation securities to become artificially inflated and that they detrimentally relied upon the integrity of the market prices in purchasing the securities. The plaintiffs seek recovery for the losses suffered when Documation's true financial situation came to light and the price of the securities declined.

The defendants moved to dismiss the complaint on the ground that it failed to state a claim upon which relief can be granted, because the plaintiffs had failed to allege direct reliance on the purportedly misleading documents. The district court denied the defendants' motion, concluding that the former Fifth Circuit in *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981) (en banc), *cert. denied,* ____ U.S. ____, 103 S.Ct. 722, 74 L.Ed.2d 949 (1983),[2] had implicitly adopted the fraud on the market theory and, therefore, the plaintiffs did not need to prove actual reliance to recover. In a subsequent order, however, the district court granted the defendants' motion to certify pursuant to 28 U.S.C. § 1292(b) its prior order holding that this circuit recognizes the fraud on the market theory as "involv[ing] a controlling question of law as to which there is substantial ground for difference of opinion . . . ." In decid-

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1 The plaintiffs also allege various state law claims which are not at issue on this appeal.

2 The Eleventh Circuit, in the en banc decision *Bonner v. City of Prichard*, 661 F.2d 1206, 1209 (11th Cir.1981), adopted as precedent decisions of the former Fifth Circuit rendered prior to October 1, 1981.

ing to certify its prior order, the district court adhered to its conclusion that *Shores* implicitly adopted the fraud on the market theory, but recognized that *Shores* could be read as approving only a very narrow version of the theory. This court agreed to hear the appeal.

I.

Reliance is one of the essential elements that a plaintiff must prove to recover in a rule 10b-5 action. *Dupuy v. Dupuy*, 551 F.2d 1005 (5th Cir.), *cert. denied*, 434 U.S. 911, 98 S.Ct. 312, 54 L.Ed.2d 197 (1977). Requiring the plaintiff to show that he reasonably relied on the defendants' misrepresentations is a means of establishing the "causal link between the misrepresentation or omission and the injuries suffered by the private plaintiff," *id.* at 1016, and of ensuring that the federal securities laws do not expose defendants to limitless liability or become transformed into merely private enforcement mechanisms. *Id.; Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88, 92 (2d Cir.1981); *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir.), *cert. denied*, 382 U.S. 811, 86 S.Ct. 23, 15 L.Ed.2d 60 (1965).

The courts have recognized, however, that in certain contexts requiring the plaintiff to prove actual reliance would effectively preclude recovery although causation in fact did exist. The Supreme Court in *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 92 S.Ct. 1456, 31 L.Ed.2d 741 (1972), thus held that where the plaintiff's claim is primarily one of failure to disclose,

> positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. . . . This obligation to disclose and this withholding of a material fact established the requisite element of causation in fact.

406 U.S. at 153-54, 92 S.Ct. at 1472 (citations omitted). In nondisclosure cases, therefore, a plaintiff may prove reliance

through a rebuttable presumption that he relied on the undisclosed information, subject to the defendant proving that the plaintiff's decision would have been unaffected even if the omitted information had been disclosed. *Rifkin v. Crow*, 574 F.2d 256, 262-63 (5th Cir.1978).[3]

The Ninth Circuit in *Blackie v. Barrack*, 524 F.2d 891 (9th Cir.1975), extended the rationale of *Affiliated Ute* to situations where the plaintiff class alleges that deception resulted in inflated security prices on the open market. Finding that in such a context proof of direct reliance "imposes an unreasonable and irrelevant evidentiary burden," *id.* at 907, the court held that the burden of proof shifts to the defendant to show either that the deception was immaterial, that an insufficient number of traders relied on the misleading information to inflate the price, or that the plaintiff purchased the securities knowing of the misrepresentation or would have still purchased the securities despite the misrepresentation. *Id.* at 906. The court concluded that such a rebuttable presumption would further the goals of the federal securities laws without dispensing with the requirement of causation, because reliance, albeit indirect reliance on the integrity of the market price, would still exist. *Id.* at 906-07.

Since *Blackie*, four other circuits have adopted the fraud on the market theory to varying degrees for rule 10b-5 actions. *See T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Authority*, 717 F.2d 1330 (10th Cir.1983), *cert. denied*, ___ U.S. ___, 104 S.Ct. 1285, 79 L.Ed.2d 687 (1984); *Panzirer v. Wolf*, 663 F.2d 365 (2d Cir.1981), *vacated as moot sub nom. Price Waterhouse v. Panzirer*, 459 U.S. 1027, 103 S.Ct. 434, 74 L.Ed.2d 594 (1982); *Shores v. Sklar*, 647 F.2d 462 (5th Cir.1981) (en banc), *cert. denied*, ___ U.S. ___, 103

3 The Court in *Affiliated Ute* did not expressly state that a "presumption" of reliance was created or that it was rebuttable. This circuit, however, as have other courts, has treated the holding of *Affiliated Ute* as creating a rebuttable presumption. *See* Note, *The Reliance Requirement in Private Actions under SEC Rule 10b-5*, 88 Harv.L.Rev. 584 (1975); *Blackie v. Barrack*, 524 F.2d 891, 906 n. 22 (9th Cir.1975).

S.Ct. 722, 74 L.Ed.2d 949 (1983).[4] No circuit court has expressly rejected the theory, *but see, Vervaecke v. Chiles, Heider & Company, Inc.*, 578 F.2d 713 (8th Cir.1978) (no presumption of reliance where new issues are involved and claims are based on affirmative misrepresentations), and the Supreme Court has yet to address the issue.

The fraud on the market theory also has received generally favorable treatment from the commmentators. *See* Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C.L.Rev. 435 (1984); Rapp, *Rule 10b-5 and "Fraud-On-the-Market"—Heavy Seas Meet Tranquil Shores*, 39 Wash. & Lee L.Rev. 861 (1982); Note, *Fraud on the Market: An Emerging Theory of Recovery Under SEC Rule 10b-5*, 50 Geo.W.L.Rev. 627 (1982); Note, *The Fraud-on-the-Market-Theory*, 95 Harv.L.Rev. 1143 (1982). The theory has been viewed as most sound where it is used in the context of class actions to eliminate the necessity of each class member proving subjective reliance and where the securities were traded on a developed and open market, so that market prices reflect available information about the corporation.[5] Black, 62 N.C.L.Rev. at 437-38. The theory, however, has been criticized when courts have applied it to undeveloped markets, *see* Note, 95 Harv.L.Rev. at 1156-58 (criticizing *Shores v. Sklar*), or used the theory to eliminate the reliance requirement entirely rather than to merely create a rebuttable presumption of reliance, *see* Black, 62 N.C.L.Rev. at 438-39; Rapp, 39 Wash. & Lee L.Rev. at 888-93 (criticizing *Panzirer v. Wolf* as using fraud on the market to extend "chain of causation" too far).

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4 The Eleventh Circuit is bound by the holding of *Shore v. Sklar* by virtue of its decision in *Bonner v. Prichard*, 661 F.2d 1206 (11th Cir.1981); see *supra* note 2.

5 The idea that securities traded on a developed market will reflect the available information on the corporation has become known as the "efficient market" thesis. Black, 62 N.C.L.Rev. at 437; *see also* Note, 95 Harv.L.Rev. at 1154-56.

II.

It is against this background of case law and commentary that we approach the former Fifth Circuit's en banc decision in *Shores*. In *Shores*, the plaintiff had bought industrial revenue bonds and alleged under rule 10b-5 that the defendant had fraudulently marketed the bonds by, among other acts, the issuance of a misleading Offering Circular. The plaintiff admitted that he had never read the Circular and that he had bought the bonds solely on the basis of his broker's recommendation. The district court had dismissed all of the plaintiff's claims on the ground that the plaintiff could not show reliance.

The en banc court affirmed the dismissal of the plaintiff's "usual 10b-5" claim based on the Offering Circular's alleged misrepresentations and omissions, because the plaintiff had failed to show the essential element of reliance. 647 F.2d at 468. The closely divided court, however, held that the plaintiff had stated a viable claim in alleging a "broader theory [under which] it would have availed him nothing to have read the Offering Circular . . . The securities laws allow an investor to rely on the integrity of the market to the extent that the securities it offers to him for purchase are entitled to be in the market place." *Id.* at 470-71.

In so holding, the majority distinguished between claims based on rule 10b-5(2) and those based on rule 10b-5(1) and (3).[6] Reliance was necessary under 10b-5(2) because liability under that section is premised directly upon the allegedly

6 Rule 10b-5 provides in part:

It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails, . . .

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

misleading statements or omissions in the documents. With regard to 10b-5(1) and (3), however, the majority found that direct reliance on the misleading documents is not required, because the language of those sections is aimed at broader schemes of securities fraud. Accordingly, in that case, the plaintiff's "lack of reliance on the Offering Circular, only one component of the overall scheme, is not determinative. *Blackie v. Barrack*, . . ." *Id.* at 469. Again citing to *Blackie*, the majority concluded that "[m]isrepresentation and omission cases under 10b-5(2) which, as we do, require reliance on the document making the misrepresentation or omitting the material fact are inapposite to a case in which the buyer relied on the integrity of the market to furnish securities which were not the product of a fraudulent scheme." *Id.* at 471.

Finally, the majority looked to the purpose of the reliance requirement for 10b-5 actions. Finding that reliance is a means of ensuring that causation exists between the defendant's acts and the plaintiff's harm, it reasoned that what constitutes a prima facie showing of causation varies with the factual context:

> Whenever the rule 10b-5 issue shifts from misrepresentation or omission in a document to fraud on a broader scale, the search for causation must shift also. The "reliance" that produces causation in the latter type of case cannot come from reading a document. It may arise from the duty to speak as in *Ute*, a scheme to manipulate the market at a time when a merger had forced a sale as in *Schlick* [*v. Penn Dixie Cement Corp.*, 507 F.2d 374 (2nd Cir.1974), *cert. denied*, 421 U.S. 976, 95 S.Ct. 1976, 44 L.Ed.2d 467 (1975)], a scheme to inflate common stock prices by misleading statements as in *Rifkin*, or a claim by a bond buyer that he relied on the market to provide securities that were not fraudulently created as we have here. The most significant common thread in all these precedents is that rule 10b-5 is not limited to a narrow right to recover for knowing fraudulent misrepresentations or omissions in disclosure documents which mislead

a securities buyer. The rule is recognized also to provide the basis for a federal cause of action for more elaborate, intentional schemes which deceive or defraud purchasers of securities.

The holding in *Shores* was thus premised on two primary rationales: the expansive language of rule 10b-5(1) and (3) and the different ways in which causation may be demonstrated depending upon the nature of the alleged fraud.

Despite the apparently broad reach of the *Shores* holding and its reliance on *Blackie*, the defendants contend that the majority adopted only a very narrow version of the fraud on the market theory, limiting its operation to the context where the securities would never have been placed on the market but for the fraud. In support of their position, the defendants note that the court stated at one point that "if [the plaintiff] proves no more than that the bonds would have been offered at a lower price or a higher rate, rather than that they would never have been issued or marketed, he cannot recover." *Id.* at 470. In another passage, the majority similarly observed that the plaintiff's "theory is not that he bought inferior bonds, but that the bonds he bought were fraudulently marketed. The securities laws allow an investor to rely on the integrity of the market to the extent that the securities it offers him for purchase are entitled to be in the market place." *Id.* at 471.

We believe that much of the confusion surrounding the *Shores* opinion[7] is clarified once the unique fact setting of the

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7 The district court read *Shores* as adopting an unqualified version of the fraud on the market theory, but recognized that "there is support for [the] position that *Shores* approved only a very narrow version of the 'fraud on the market' theory." The court below is not alone in its uncertainty of how to read *Shores*, as the courts and commentators have also disagreed as to whether *Shores* adopted an expansive approach to the fraud on the market theory or a more restrictive version. *Compare Kennedy v. Nicastro*, 517 F.Supp. 1157 (N.D.Ill.1981) (*Shores* adopted limited version of fraud on the market); Note, 95 Harv.L.Rev. 1143 (1982) *with T.J. Raney & Sons v. Fort Cobb Oklahoma Irrigation Fuel Authority*, 717 F.2d 1330, 1333 (10th Cir. 1983) (*Shores* "extends the protection of rule 10b-5"); Brunelle, *The Shores Case—Expansion of the "Fraud-on-the-Market" Doctrine*, 9 Sec.Regul.Law Journal 390 (1982); Rapp, 39 Wash. & Lee L.Rev. 861 (1982). *See also*,

case is taken into account. Whereas the "classic" fraud on the market case arises out of transactions on an open and developed market, in *Shores* the plaintiff was buying newly issued bonds. The *Shores* court was therefore faced with the difficult task of applying a doctrine developed in one context, the open market, to the not entirely analogous setting of newly issued securities. Indeed, the *Shores* dissent objected to the majority's opinion not because the majority was adopting the fraud on the market theory, but because it saw the opinion as extending the theory in an unprecedented manner. 647 F.2d at 477-79 (Randall, J., dissenting).

The *Shores* holding was thus necessarily confined to the limited setting of newly issued securities traded on an undeveloped market and did not determine whether the fraud on the market theory should apply to the open market context. It is that question which is now before this court.

III.

Although the *Shores* court did not decide the precise issue before us, we still find that to a large degree the decision dictates that this circuit recognize the fraud on the market theory as a basis for recovery where the defendant's deception inflates open market stock prices. To hold otherwise would result in this circuit adopting the theory in a setting where its applicability has been questioned, and rejecting its use where it best advances the goals of the federal securities laws.

As noted above, the fraud on the market theory finds its greatest justification when applied to class actions alleging fraudulent misrepresentations or omissions that affected security prices on a developed open market. In such a context, it is reasonable to assume that misinformation disseminated into the marketplace will affect the market price. It is also reasonable to allow a plaintiff to allege that he relied on the integrity

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Black, 62 N.C.L.Rev. 435 (1984) (*Shores* represents distinct version of fraud on the market); L. Loss, *"Fraud" and Civil Liability under the Federal Securities Laws* (Federal Judicial Center 1983), p. 58 n. 152 (*Shores* is variation of fraud on the market).

of the market prices in purchasing the securities and then shift the burden to the defendant to disprove actual reliance. *Blackie*, 524 F.2d at 907.

The *Shores* opinion has been criticized primarily because it extended fraud on the market to new issues in an undeveloped market. In such a setting, it is not necessarily reasonable to presume that misinformation will affect the market price, as information on an undeveloped market does not readily affect market prices and, in the case of new securities, the price will be set by the offeror and underwriters, not the market. *See*, Note, 95 Harv.L.Rev. at 1156-58; Black, 62 N.C.L.Rev. at 453. Moreover, the causal nexus between the misleading information and the plaintiff's decision to purchase is more direct when it affects a security's market price than when the misleading information goes merely to the legitimacy of the issuance of the securities themselves. *See*, Rapp, 39 Wash. & Lee L.Rev. at 886-87.

Without impugning the ultimate soundness of the decision in *Shores*, it strikes us as untenable to adopt the fraud on the market theory in a context where its application is most questionable, while precluding its application to transactions in a developed open market, as in this case, where its operation is most justifiable. Moreover, when viewed from this perspective, the language in *Shores* disallowing recovery by a plaintiff where his claim is simply that the price of newly issued securities was adversely affected by a deficient Offering Circular, 647 F.2d at 471, becomes understandable not as a rejection of the general fraud on the market theory, but as a limitation on the theory's application to the unique context of new issue offerings.[8] In such a setting, it is reasonable to allow recovery

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8 The majority in *Shores* noted that the record was unclear as to whether the plaintiff had bought the bonds as part of the primary offering or on the secondary market. 647 F.2d at 467. The majority did not find the distinction to be important, nor do we find it important here. The important fact is not whether the securities were bought on the primary or secondary market, but whether the securities were actively traded so that the market price would be influenced by the available information. *See*, Black, 62 N.C.L.Rev. at 473; Note, 95 Harv.L.Rev. at 1161. Most courts and commentators have elected simply to treat *Shores* as involving newly issued

on the fraud on the market theory where the securities could not have been marketed but for the fraud, because there the information in the Offering Circular and other documents will affect their marketability,[9] but not allow recovery for diminished value because the misinformation will not have an adequate causal nexus to the price. *See T.J. Raney*, 717 F.2d at 1333; Note, Geo.Wash.L.Rev. at 651; Black, 62 N.C.L.Rev. at 453.

We also find support for our conclusion in the reasoning and language of the *Shores* opinion itself. First, the majority relied heavily on the *Blackie* decision and other fraud on the market cases, 647 F.2d at 469, 471 n. 11, without any indication that it would reject the full scope of their holdings when applied to the open market context. Second, the opinion specifically stated that a plaintiff need not show actual reliance on a misleading document where the allegation is "one of a scheme to inflate common stock prices by misleading statements,"[10] *id.*

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securities and not focused on the primary-secondary market distinction. *See, e.g., T.J. Raney*, 717 F.2d at 1332-33; Note, 95 Harv.L.Rev. at 1153.

9 The Ninth Circuit in *Arthur Young & Co. v. United States District Court*, 549 F.2d 686 (9th Cir.1977) similarly concluded that:

> [j]ust as the open market purchaser relies on the integrity of the market and the price of the security traded on the open market to reflect the true value of the securities in which he invests, so the purchaser of an original issue security relies, at least indirectly, on the integrity of the regulatory process and the truth of any representations made to the appropriate agencies and the investors at the time of the original issue.

Id. at 695.

10 The court cited *Rifkin v. Crow*, 574 F.2d 256 (5th Cir.1978), as an example of a case involving "a scheme to inflate common stock prices by misleading statements." 647 F.2d at 472. The *Rifkin* court had favorably discussed the fraud on the market theory but found it unnecessary to decide whether to adopt it. 574 F.2d at 263-64. The importance of *Rifkin* for our purposes is that the plaintiff's complaint in *Rifkin* was based on inflated market prices due to misstatements and omissions, and not on the marketability of the securities themselves. The majority's approving citation of *Rifkin* thus further indicates that it did not intend to adopt the fraud on the market theory only in cases where the plaintiff alleged that the securities were unmarketable.

at 472, and contrasted that situation with "a claim by a bond buyer that he relied on the market to provide securities that were not fraudulently created as we have here," *id*. The *Shores* court thus recognized that the fact setting before it was of a distinct nature and that there are other situations where "rule 10b-5 is not limited to a narrow right to recover for knowing fraudulent misrepresentations or omissions in disclosure documents which mislead a securities buyer." *Id*. Finally, the language in 10b-5(1) and (3), on which the majority relied to find a cause of action in *Shores*, does not provide any principled basis for not allowing recovery where market prices are fraudulently inflated on the open market.

We thus read *Shores* as implicitly approving of the general fraud on the market theory, although limiting its application where new securities are involved to situations where but for the fraud the securities would not have been marketable. The bottom line of *Shores* is that a plaintiff cannot recover if his only claim is that documents on which he did not rely contained misrepresentations; he can recover, however, where the allegation is of fraud "on a broader scale"[11] which affects the market place so that "it would have availed [the plaintiff] nothing to have read [the misleading documents]." *Id*. at 470-71.

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11 *Shores* is arguably a more narrow holding than *Blackie* in that it requires an allegation of a fraudulent scheme under 10b-5(1), 647 F.2d at 470 n. 8, 472, and not merely a claim that the misleading documents violated 10b-5(2). *See*, Black, 62 N.C.L.Rev. at 453; Note, 95 Harv.L.Rev. at 1153 (*Shores* may require conspiracy among defendants in fraudulently issuing securities). We decline to decide what exactly constitutes fraud on a "broader level" or a scheme or manipulation for the purposes of the opinion in *Shores*. *Cf*. Rapp, 39 Wash. & Lee L.Rev. at 84-85 (*Shores'* requirement of "manipulation" not very strict). We do note, however, that the majority's concern that the plaintiff allege fraud beyond the "usual 10b-5" claim, 647 F.2d at 468, appears to be directed at ensuring that indirect reliance did in fact exist as it would not have availed the plaintiff to have read the disputed documents. 647 F.2d at 470-71. We further note that the language of 10b-5(3), on which the majority partially relied, does not require a "scheme" but simply "acts, practices and courses of business and conduct which operated as a fraud and deceit . . . ."

Finally, we find independently of the reasoning in *Shores* that this circuit should recognize the fraud on the market theory when applied to class actions alleging that the defendant's deception inflated stock prices in the open market. We agree with the Ninth Circuit that:

> causation is adequately established in the impersonal stock exchange context by proof of purchase and of the materiality of misrepresentations, without direct proof of reliance. Materiality circumstantially establishes the reliance of some market traders and hence the inflation in the stock price—when the purchase is made the causational chain between defendant's conduct and plaintiff's loss is sufficiently established to make out a prima facie case.

Blackie, 524 F.2d at 906 (citations omitted).

Nor do we find, as the defendants argue, that the legislative history of the Securities Exchange Act of 1934 necessitates a different conclusion because Congress intended to make reliance on the misleading statements a prerequisite for recovery.[12] The fraud on the market theory as articulated in *Blackie* does not eliminate the need for the plaintiff to show reliance; it simply recognizes that reliance may be presumed where securities are traded on the open market, subject to the defendant proving that the misrepresentations were not material or that the plaintiff's decision to purchase was or would have been unaffected if he had known the true facts. *Blackie*, 524 F.2d at 906. The theory thus actually facilitates Congress' intent in enacting the federal securities law by enabling a purchaser to rely on an expectation that the securities markets are free from fraud. *Id.* at 907.

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12 The defendants cite as support the legislative history of Section 18 of the Securities Exchange Act of 1934, which provides a remedy for those injured by misleading statements of material facts in reports filed with the Securities and Exchange Commission. *See* 78 Cong.Rec. at 7701 (April 30, 1934) (statements of Rep. Sam Rayburn); S. Report No. 792, 73d Cong. 2d Sess. 13 (1934). We assume for the purposes of this discussion that sections 10(b) and 18 of the Act are sufficiently analogous to make the legislative history of the latter section relevant to an understanding of section 10(b).

IV.

Having concluded that the former Fifth Circuit's decision in *Shores v. Sklar* implicitly approved of the general fraud on the market theory, and that the theory advances the purposes of the Securities Exchange Act of 1934, the district court's order denying the defendants' motion to dismiss the complaint is AFFIRMED.

Order of the United States District Court for the Middle District of Florida Denying Motion to Dismiss

UNITED STATES DISTRICT COURT
MIDDLE DISTRICT OF FLORIDA
ORLANDO DIVISION

No. 80-555-Orl-Civ-EK

August 18, 1982

DAVID A. and SYLVIA S. LIPTON,

Plaintiffs,

vs.

DOCUMATION, INCORPORATED, et al,

Defendants.

MEMORANDUM AND ORDER

Plaintiffs, David A. and Sylvia S. Lipton bring this proposed class action on behalf of themselves and other purchasers of Documation, Incorporated ("Documation") securities, alleging violations of federal securities laws, common law claims of fraud and deceit and claims of negligence or gross negligence.

The defendants are Documation, a Delaware corporation which designs, develops, manufactures and markets a variety of computer products which are described in the amended and supplemental complaint ("complaint"); S. Ray Halbert, Robert S. Ames, John H. Holcomb, James F. Morgan and Richard J. Testa, directors of Documation during the proposed class period, who also held other positions with Documation during the period, as set forth in the complaint; Textron, Inc. ("Tex-

tron"), a 27% shareholder of Documation, which is alleged to be a controlling person of Ames and Morgan within the meaning of Section 20(a) of the Securities Exchange Act of 1934; and Peat, Marwick, Mitchell & Co. ("PMM"), Documation's public auditors.

The federal claims arise out of alleged violations of Section 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder by the Securities and Exchange Commission.

The complaint contains four counts. Count I alleges violation of Section 10(b) and Rule 10b-5 against Documation and the individual defendants. Textron is alleged to be liable under Count I as a controlling person by virtue of Section 20(a). Count II alleges violation of Section 10(b) and Rule 10b-5 by PMM. Count III is directed against all defendants for common law fraud and deceit. Count IV alleges liability of all defendants based upon negligence or gross negligence under state law.

The defendants have not answered, but have moved to dismiss the complaint pursuant to Rules 9(b) and 12(b)(6) of the Federal Rules of Civil Procedure on the grounds that it fails to (i) plead fraud with particularity, and (ii) state a claim upon which relief can be granted.

The complaint, in essence, alleges that the market prices of Documation securities were artificially inflated by the defendants' deceptive activities which involved the dissemination of financial reports grossly overstating by millions of dollars the purported revenues, earnings, net worth and assets of Documation. In reliance upon the integrity of the market, plaintiffs and the proposed class members allegedly purchased Documation securities at the inflated prices. Plaintiffs' complaint presents a "fraud on the market" theory of action.

I. PLEADING FRAUD UNDER RULE 9(b).

Rule 9(b) of the Federal Rules of Civil Procedure provides:

> "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particu-

larity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally."

The purposes of Rule 9(b) are straight forward. They are particularly important in securities litigation. As summarized from *Ross* v. *A. H. Robins and Company, Inc.*, 607 F.2d 545, 557 (2nd Cir.1979):

> "This rule . . . generally serves two important purposes. First, it assures the defendant of 'fair notice of what the plaintiff's claim is and the grounds upon which it rests.' [Citing cases.] . . . Secondly, the specificity requirements grows out of 'the desire to protect defendants from the harm that comes to their reputations or to their goodwill when they are charged with serious wrongdoing . . .' In the context of securities litigation . . . [i]t operates to diminish the possibility that 'a plaintiff with a largely groundless claim [will be able] to simply take up the time of a number of other people [by extensive discovery], with the right to do so representing *an interrorem* increment of the settlement value, rather than a reasonably founded hope that the process will reveal relevant evidence . . .' "

Professionals, however, are not insulated from claims of fraud by Rule 9(b) where a complaint alleges the fraudulent acts with particularity. *Felton* v. *Walston and Co.*, 508 F.2d 577, 581 (2nd Cir.1974). "[T]he requirement of Rule 9(b) is met where there is sufficient identification of the circumstances constituting fraud so that the defendant can prepare an adequate answer to the allegation." *Denny* v. *Carey*, 72 F.R.D. 574 (E.D.Pa.1976) and cases cited therein.

The complaint alleges that Documation issued certain documents which contained material misrepresentations or omissions. The complaint identifies the documents and specifies the information which is alleged to be misrepresented or omitted. The complaint further identifies the cause of the misrepresentations or omissions.

For example, the complaint alleges misstatements and omissions in Documation's Annual Report for the 1977 fiscal year. The complaint specifically sets forth the items alleged to be

misrepresentations or omissions. The complaint then specifies why the items are misrepresentations or omissions. In regard to the 1977 Annual Report, the complaint alleges, inter alia, that "the reported net earnings for the 1977 fiscal year were overstated by at least 55% or approximately $2,013,000, said overstatement resulting from a grossly inadequate loss reserve and provision of only $1,036,000, instead of at least $3,049,000, for the allowance for losses on sales returns and uncollectible receivables."

The complaint dutifully follows this procedure for each alleged misrepresentation or omission. Documation is not left guessing at what the charges of wrongdoing are. The allegations of the circumstances constituting fraud are set forth with sufficient particularity to put Documation on fair notice of the claims so that an answer can be framed.

The individual defendants, as directors, officers and/or members of the Audit Committee of Documation are alleged to have had the responsibility for the active management of Documation and the power and duty to influence the policies and actions of Documation including the accounting and financial functions of Documation, and matters relating to the appointment and activities of its public auditors. Along with Documation, they are alleged to have, knowingly or recklessly caused, participated in or approved a common course of conduct (as set forth in the complaint) which operated as a fraud upon the plaintiff and the proposed class. They are charged with the same set of facts that are alleged against Documation.

The individual defendants are, just like Documation, put on fair notice of the plaintiffs' claims against them. They maintain, however, that Rule 9(b) has not been satisfied by the complaint's failure to allege the details of fraud as to each individual defendant. Faced with a similar claim in *Barotz* v. *Monarch General, Inc.*, [1974-1975] CCH Fed.Sed.L.Rep. ¶ 94,933 (S.D.N.Y.1975), the Court stated:

> "In my view, the arguments here are not particularly impressive. To begin with, it is to be presumed that

> Monarch's directors acted as a group in approving the reports in question. Further, plaintiff cannot be expected to be privy to the directors' meeting discussions, either singularly or as a group. For these reasons any overly literal application of Rule 9(b) ought to be avoided. Of equal importance is the general rule that Rule 9(b) does not require particularization of allegations of fraudulent intent or scienter." 2A *Moore's Federal Practice*, ¶ 9.03 at 1937.

For the same reasons, this Court finds the complaint to sufficiently allege the role of each individual defendant in the fraud.

The claim against PMM is essentially that they knew or recklessly disregarded the fact that Documation's financial statements, on which PMM reported, were false and misleading as set forth in Count I against the other defendants. PMM is alleged to have failed to disclose the true state of affairs in its reports, and to have thereby manipulated and inflated the market price of Documation's securities. The complaint informs PMM of the financial statements and its reports thereon which are the basis of plaintiffs' claims and of the alleged misrepresentations and omissions. The complaint alleges that PMM knew of the misrepresentations and omissions. Going further, to show a reckless disregard of the facts, the complaint details alleged violations by PMM of generally accepted auditing standards which are charged against it in connection with its examinations and reports on Documation's financial statements. The allegations of the complaint against PMM are set forth with sufficient particularity to put it on fair notice of plaintiffs' claims.

PMM strenuously argues that the complaint fails to satisfy the requirements of Rule 9(b) because there are no allegations identifying the *facts* which PMM knew which rendered their reports false and misleading. The Courts' discussion in *Tanzer v. Sharon Steel Corp.*, [1979] CCH Fed.Sec.L.Rep. ¶ 96,915 (S.D.N.Y.1979) is applicable here:

> "The defendant wants plaintiff to plead the circumstances underlying this knowledge—to-wit, *how* the auditors

> knew or should have known of the alleged misrepresentations.
>
> Although there is authority which could be read to support defendant's position, I read Rule 9(b) and the greater weight of judicial guidance to condone allegations of knowledge without specifying the circumstances from which that knowledge is inferred. Rule 9(b) is explicit "Malice, intent, *knowledge*, and other condition of mind of a person may be averred generally." The courts have followed this in Section 10(b) cases where such knowledge is an element of fraud. *Heit* v. *Weitzen*, 402 F.2d 909, 914 (2nd Cir. 1968), *cert. denied*, 395 U.S. 903 (1969) ("charge that defendants 'knew or should have known' adequately alleges actual knowledge of the falsity of the statements").

The "authority" referred to as supporting defendant's position in the above passage is *Weinberger* v. *Kendrick*, 451 F.Supp. 79, 83-84 (S.D. N.Y. 1978). PMM's arguments here rely heavily upon the *Weinberger* decision. This Court, however, chooses to follow the reasoning of the Court in *Tanzer.* The Court, therefore, finds the averments of PMM's knowledge of the fraud to be sufficient under Rule 9(b).

It is also asserted by the defendants that palintiffs are relying upon "neutral" facts and are pleading "fraud by hindsight". It is well settled that the allegation of the complaint must be taken as true for purposes of the motion to dismiss. *Conley* v. *Gibson*, 355 U.S. 41 (1957). With that thought in mind, the Court is of the opinion that dismissal on these grounds would be inappropriate at this state of the proceeding.

For the reasons set forth above, the defendants' motions to dismiss based upon Counts I and II failing to satisfy Rule 9(b) will be denied. For the same reasons, the Court finds the allegations of common law fraud in Count III sufficient under Rule 9(b).

Order of the United States District Court for the Middle District of Florida Denying Motion to Dismiss

II. STATING A CLAIM UPON WHICH RELIEF CAN BE GRANTED.

Rule 9(b) and Rule 12(b)(6) necessarily overlap in their application, since failure to satisfy Rule 9(b) will result in a failure to state a claim upon which relief can be granted. Because of this the defendants reassert their arguments relating to pleading the element of scienter as a basis for dismissal under Rule 12(b)(6). For the reasons set forth earlier regarding these arguments, the Court again rejects the defendants' contention.

Defendants next assert that under *Sante Fe Industries, Inc.* v. *Green*, 430 U.S. 462 (1977) the complaint should be dismissed under Rule 12(b)(6). Defendants argue that the thrust of the complaint is mismanagement and waste and that the allegations show no more than state law violations. As stated below, however, the Court is satisfied that plaintiffs' complaint presents a viable Section 10(b) and Rule 10b-5 claim under the "fraud on the market" theory. That being the case, whether or not defendants' action also involved fiduciary breaches does not deprive the Court of jurisdiction.

Defendants assert that the plaintiffs' failure to allege actual reliance upon the misrepresentations and omissions is fatal to the action. The defendants rely upon the decision in *Shores* v. *Sklar*, 647 F.2d 462 (5th Cir. 1981) (en banc), for the proposition that the fraud on the market theory of liability presented in the complaint is not viable in this circuit.[1]

Prior to the *Shores* decision, district courts in the Fifth Circuit had indicated approval of the fraud on the market theory. *Sargent* v. *Genesco, Inc.*, 75 F.R.D. 79 (M.D. Fla. 1977); *In re LTV Securities Litigation*, 88 F.R.D. 134 (N.D. Texas 1980). Also, in *Rifkin* v. *Crow*, 574 F.2d 256, (5th Cir. 1978), the Fifth Circuit noted the Second and Ninth Circuits recognition of the fraud on the market theory, but stated that

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1 The Fifth Circuit's decision in *Shores* is binding precedent in the Eleventh Circuit under *Benner* v. *City of Prichard, Alabama*, 661 F.2d 1206 (5th Cir. 1981).

the Fifth Circuit had yet to decide whether reliance could be presumed in fraud on the market situations. The Court did not find it necessary to make that decision in *Rifkin*.

The Court in *Shores* was not faced with the typical fraud on the market fact situation. The Court did not expressly adopt the fraud on the market theory recognized in the Second and Ninth Circuits, but implicit in *Shores* is an approval of the theory. The *Shores* decision relied heavily upon *Blackie* v. *Barrack*, 524 F.2d 891 (9th Cir. 1975), *cert. denied* 429 U.S. 816 (1976) (the leading case sanctioning the fraud on the market theory) in its holding that the fraud on the market theory permitted recovery by a plaintiff who purchased securities, without actual reliance on the documents which were part of a fraudulent scheme, when the securities would never have been issued without the fraud. Far from limiting the fraud on the market theory, *Shores* extended the open market causation approach to the fact situation before the Court.

The allegations of the complaint sufficiently allege actionable Section 10(b) and Rule 10-b-5 fraud, under the fraud on the market theory. Accordingly, defendants' motions to dismiss Counts I and II under Rule 12(b)(6) will be denied.

Defendant Halbert and PMM have also moved to dismiss Count IV, the negligence claim, under Rule 12(b)(6). The allegations of Count IV are sufficient under Florida law to state a claim against defendant Halbert for negligence. As to PMM, however, it appears that Florida law precludes a negligence action by third parties against an accountant in the absence of privity. *See Investment Corporation of Florida* v. *Buchman*, 208 So.2d 291 (Fla. 2d DCA) cert. discharged 216 So.2d 748 (Fla. 1978) and *Nortek, Inc.* v. *Alexander Grant & Company*, 532 F.2d 1013 (5th Cir. 1976) *cert. denied*, 429 U.S. 1042 (1977). Therefore, PMM's motion to dismiss Count IV under Rule 12(b)(6) will be granted.

For the reasons set forth above, it is,

ORDERED that the defendants' motions to dismiss under Rule 9(b) are hereby denied; it is further,

Order of the United States District Court for the Middle District of Florida Denying Motion to Dismiss

ORDERED that the motion to dismiss Count IV of the amended and supplemental complaint by Peat, Marwick, Mitchell & Co. under Rule 12(b)(6) is hereby granted; it is further,

ORDERED that the defendants' remaining motions to dismiss under Rule 12(b)(6) are hereby denied; and it is further,

ORDERED that the defendants shall file their answers to the amended and supplemental complaint within thirty (30) days from the date of this order.

DONE and ORDERED in Chambers at Orlando, Florida, this 18th day of August, 1982.

/s/ ELIZABETH A. KOVACHEVICH
Elizabeth A. Kovachevich
United States District Judge

Order of the United States District Court for the Middle District of Florida Certifying Controlling Question of Law Pursuant to 28 U.S.C. § 1292(b)

UNITED STATES DISTRICT COURT
MIDDLE DISTRICT OF FLORIDA
ORLANDO DIVISION

No. 80-555-Orl-Civ-EK

December 1, 1982

DAVID A. and SYLVIA S. LIPTON,

Plaintiffs,

vs.

DOCUMATION, INCORPORATED, et al,

Defendants.

MEMORANDUM AND ORDER

By their Amended and Supplemental Class Action Complaint ("complaint"), plaintiffs seek to assert a class action claim pursuant to Section 10(b) of the Securities Exchange Act of 1934 [15 U.S.C. § 78j(b)] and Securities and Exchange Commission Rule 10b-5, as well as various pendent state claims. The plaintiffs concede that their federal securities law claim is based on what has become known as the "fraud on the market" theory. Thus, it is alleged that "plaintiffs and other members of the class relied, to their damage, on the integrity of the market prices of Documation securities during the class period in purchasing their Documation securities"; and that, as a result of the supposed misrepresentations, "the market prices of Documation securities were artificially inflated during

the class period" (Complaint, ¶ 49). There is no allegation that either plaintiff actually relied upon any supposed misrepresentation made by any defendant. Likewise, it is not alleged that the Documation stock would never have been marketed but for the fraud alleged.

Defendants moved to dismiss the complaint on the ground that it fails to state a claim upon which relief can be granted because it lacks any allegation of actual reliance by either plaintiff upon any supposed misrepresentation made by any defendant. *See generally Huddleston* v. *Herman & MacLean*, 640 F.2d 534, 543 (5th Cir.1981), *cert. granted*, 102 S.Ct. 1766 (1982); *Dupuy* v. *Dupuy*, 551 F.2d 1005, 1014 (5th Cir.1977); *Simon* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 482 F.2d 880, 884 (5th Cir.1973). Defendants argued further that the decision in *Shores* v. *Sklar*, 647 F.2d 462 (5th Cir.1981) (en banc), *petition for cert. filed*, 50 U.S.L.W. 3377 (U.S. Nov. 2, 1981) (No. 81-839), requires dismissal because the Court in *Shores* adopted only a qualified version of the "fraud on the market" theory, which does not apply to the facts as alleged in this case.* According to defendants, *Shores* holds that the requirement of pleading and proving reliance in an action under Section 10(b) of the 1934 Act and Rule 10b-5 is excused only when a plaintiff pleads (and subsequently proves) that the security he purchased "would never have been issued or marketed" (647 F.2d at 470) but for the fraud alleged and that a plaintiff who alleges and is able to prove only that the fraud alleged had an adverse effect upon the price of the security purchased is not entitled to recover.

On August 18, 1982, this Court issued a Memorandum and Order denying defendants' motions to dismiss. In doing so, this Court said:

> "The Court [in *Shores*] did not expressly adopt the fraud on the market theory recognized in the Second and Ninth Circuits, but implicit in *Shores* is an approval of the

* The *Shores* decision is binding precedent in the Eleventh Circuit. *Bonner* v. *City of Prichard, Alabama*, 661 F.2d 1206 (11th Cir. 1981).

theory. The *Shores* decision relied heavily upon *Blackie* v. *Barrack*, 524 F.2d 891 (9th Cir.1975), *cert. denied* 429 U.S. 816 (1976) (the leading case sanctioning the fraud on the market theory) in its holding that the fraud on the market theory permitted recovery by a plaintiff who purchased securities, without actual reliance on the documents which were part of a fraudulent scheme, when the securities would never have been issued without the fraud. Far from limiting the fraud on the market theory, *Shores* extended the open market causation approach to the fact situation before the Court." (Memorandum and Order at 11-12.)

Defendant Peat Marwick Mitchell & Co. ("PMM") (in a motion joined by the remaining defendants) promptly requested the Court to amend its August 18, 1982 Memorandum and Order by certifying, pursuant to Title 28, United States Code, Section 1292(b), that the Memorandum and Order "involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal from the order may materially advance the ultimate termination of the litigation." The "controlling question of law" which PMM urges is involved is:

> "Whether a complaint seeking damages for alleged violations of Section 10(b) of the Securities Exchange Act of 1934 [15 U.S.C. § 78j(b)] and Securities and Exchange Commission Rule 10b-5 states a claim upon which relief can be granted when the complaint, asserting a 'fraud on the market' theory, alleges merely that plaintiff purchased securities relying 'on the integrity of the market prices' of those securities and that because of the misrepresentations and omissions alleged, 'the market prices of . . . [the] securities were artificially inflated,' and there is no allegation that the securities would not have been marketed at all but for the misrepresentations and omissions complained of."

After carefully considering the memoranda filed by the parties and oral argument, the Court adheres to its original

conclusion that *Shores* implicitly accepted an unqualified version of the "fraud on the market" theory, such as that explicitly adopted in *Panzirer* v. *Wolf*, 663 F.2d 365 (2d Cir. 1981), *cert. granted sub nom. Price Waterhouse* v. *Panzirer*, 102 S.Ct. 3481 (1982); and *Blackie* v. *Barrack*, 524 F.2d 891 (9th Cir.1975), *cert. denied*, 429 U.S. 816 (1976). However, the Court recognizes that there is support for PMM's position that *Shores* approved only a very narrow version of the "fraud on the market" theory. *See, e.g., Dekro* v. *Stern Brothers & Co.*, 540 F.Supp. 406 (W.D.Mo.1982); *Kennedy* v. *Nicastro*, 517 F.Supp. 1157 (N.D.Ill.1981); Note, *The Fraud-on-the-Market Theory*, 95 Harv.L.Rev.1143 (1982).

Considering the criteria for certification contained in Section 1292(b), it is apparent that the question involved in the Court's August 18, 1982 Memorandum and Order is purely a legal one. Likewise, because the claim under Section 10(b) and Rule 10b-5 provides the sole basis for subject matter jursidiction, it is apparent that the question is a controlling one. Moreover, as previously indicated, there is substantial ground for difference of opinion regarding the extent to which *Shores* accepted and approved the "fraud on the market" theory. Finally, there is a substantial likelihood that an immediate appeal under Section 1292(b) might materially advance the ultimate termination of this litigation, while the delay resulting from such an appeal would appear to be minimal given the time restraints imposed by Rule 5, Federal Rules of Appellate Procedure. In short, it would appear that the question regarding the extent to which *Shores* allows a plaintiff to plead and prove "fraud on the market" as an alternative to pleading and proving actual reliance is precisely the type of question for which Section 1292(b) was drafted. *See* S. Rep. No. 2434, 85th Cong., 2d Sess., *reprinted in* 1958 U.S. Code Cong. & Ad. News 5255; 9 Moore's Federal Practice ¶ 110.22[2] at 259.

For the reasons set forth above, it is,

ORDERED that the Court's Memorandum and Order of August 18, 1982, is hereby amended by adding at the end thereof the following paragraph:

Order of the United States District Court for the Middle District of Florida Certifying Controlling Question of Law Pursuant to 28 U.S.C. § 1292(b)

"The Court certifies that this Memorandum and Order involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal may materially advance the ultimate termination of this litigation. The controlling question of law is: Whether a complaint seeking damages for alleged violations of Section 10(b) of the Securities Exchange Act of 1934 [15 U.S.C. § 78j(b)] and Securities and Exchange Commission Rule 10b-5 states a claim upon which relief can be granted when the complaint, asserting a 'fraud on the market' theory, alleges merely that plaintiff purchased securities relying 'on the integrity of the market prices' of those securities and that because of the misrepresentations and omissions alleged, 'the market prices of . . . [the] securities were artificially inflated,' and there is no allegation that the securities would not have been marketed at all but for the misrepresentations and omissions complained of."

DONE and ORDERED in Chambers at Orlando, Florida, this Dec. 1, 1982 day of December, 1982.

/s/ ELIZABETH A. KOVACHEVICH

Elizabeth A. Kovachevich

United States District Judge

Order of the United States Court of Appeals for the Eleventh Circuit Granting Application for Leave to Appeal from an Interlocutory Order

IN THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

No. 82-2233

DOCUMATION, INC., et al.,

Petitioner,

—versus—

DAVID A. and SYLVIA S. LIPTON,

Respondents.

On Application for Leave to Appeal
from an Interlocutory Order

January 25, 1983

Before:

RONEY, VANCE and ANDERSON,
Circuit Judges.

BY THE COURT:

IT IS ORDERED that the petition for leave to appeal from interlocutory order is *Granted.*

RSV
PHR
RLA

Judgment of the United States Court of Appeals for the Eleventh Circuit

UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

No. 83-3126

D.C. Docket No. 80-555-ORL-CIV-Y

DAVID A. LIPTON and SYLVIA S. LIPTON,

Plaintiffs-Appellees,

—versus—

DOCUMATION, INC., et al.,

Defendants-Appellants.

Appeal from the United States District Court for the Middle District of Florida

Before:

KRAVITCH and ANDERSON, *Circuit Judges,* and TUTTLE, *Senior Circuit Judge.*

JUDGMENT

This cause came on to be heard on the transcript of the record from the United States District Court for the Middle District of Florida, and was argued by counsel;

Judgment of the United States Court of Appeals for the Eleventh Circuit

ON CONSIDERATION WHEREOF, it is now here ordered and adjudged by this Court that the order of the District Court appealed from, in this cause be, and the same is hereby, AFFIRMED;

It is further ordered that defendants-appellants pay to plaintiffs-appellees, the costs on appeal to be taxed by the Clerk of this Court.

Entered: June 18, 1984

For the Court: Spencer D. Mercer, *Clerk*

By: /s/ (illegible)

Deputy Clerk

ISSUED AS MANDATE: August 2, 1984

Order of the United States Court of Appeals for the Eleventh Circuit Denying Petition for Rehearing and Suggestion for Rehearing En Banc

IN THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

No. 83-3126

DAVID A. LIPTON and SYLVIA S. LIPTON,

Plaintiffs-Appellees,

—versus—

DOCUMATION, INC., et al.,

Defendants-Appellants.

Appeal from the United States District Court for the Middle District of Florida

ON PETITION FOR REHEARING AND SUGGESTION FOR REHEARING EN BANC

(Opinion June 18, 1984, 11 Cir., 198__, ____ F.2d ____).
(July 23, 1984)

Before:

KRAVITCH and ANDERSON, *Circuit Judges*, and TUTTLE, *Senior Circuit Judge*.

Order of the United States Court of Appeals for the Eleventh Circuit Denying Petition for Rehearing and Suggestion for Rehearing En Banc

PER CURIAM:

(✓) The Petitions for Rehearing are DENIED and no member of this panel nor Judge in regular active service on the Court having requested that the Court be polled on rehearing en banc (Rule 35, Federal Rules of Appellate Procedure; Eleventh Circuit Rule 26), the Suggestion for Rehearing En Banc is DENIED.

( ) The Petitions for Rehearing are DENIED and the Court having been polled at the request of one of the members of the Court and a majority of the Circuit Judges who are in regular active service not having voted in favor of it (Rule 35, Federal Rules of Appellate Procedure; Eleventh Circuit Rule 26), the Suggestion for Rehearing En Banc is also DENIED.

( ) A member of the Court in active service having requested a poll on the reconsideration of this cause en banc, and a majority of the judges in active service not having voted in favor of it, rehearing en banc is DENIED.

ENTERED FOR THE COURT:

/s/ Phyllis Kravitch
United States Circuit Judge

Amended and Supplemental Class Action Complaint

UNITED STATES DISTRICT COURT
MIDDLE DISTRICT OF FLORIDA
ORLANDO DIVISION

Case No. 80 555-ORL-CIV-Y

DAVID A. and SYLVIA S. LIPTON,

Plaintiffs,

—against—

DOCUMATION, INC., S. RAY HALBERT, RICHARD J. TESTA, ROBERT S. AMES, JOHN H. HOLCOMB, JR., JAMES F. MORGAN, PEAT MARWICK MITCHELL & CO. and TEXTRON, INC.,

Defendants.

AMENDED AND SUPPLEMENTAL
CLASS ACTION COMPLAINT

Plaintiffs Demand A Trial By Jury

Plaintiffs, David A. and Sylvia S. Lipton, by their attorneys Tew, Critchlow, Sonberg, Traum and Friedbauer and Wolf Popper Ross Wolf & Jones, for their Amended and Supplemental Class Action Complaint ("Complaint") herein allege upon information and belief, except as to the paragraphs which pertain to the named plaintiffs which are alleged upon knowledge, as follows:

JURISDICTION AND VENUE

1. This Court has jurisdiction of this litigation under Section 27 of the Securities Exchange Act of 1934, (referred to

herein as the "Exchange Act") as amended [15 U.S.C. § 78aa] and the principles of pendent jurisdiction.

2. The claims herein arise under Section 10(b) and Section 20(a) of the Exchange Act, Rule 10b-5 of the rules and regulations promulgated by the Securities Exchange Commission, and under state law.

3. Venue is properly laid in this District because many of the acts and transactions alleged herein occurred in this District. In addition, a principal defendant, Documation Inc. ("Documation") is situated in this District and most, if not all, of the other defendants reside or transact business in this District.

4. In connection with the violative acts and transactions alleged in this Complaint, defendants, directly or indirectly, used the means and instrumentalities of interstate commerce including the mails and the facilities of national securities exchanges.

5. With regard to the allegations made by plaintiffs on information and belief, the bases for such information and belief is derived from information in proxy statements, 10-K and 10-Q reports, 8-K reports and other documents publicly issued or filed by Documation, and in newspaper articles concerning Documation (including the documents specificially referred to in this Complaint) and from reasonable inferences to be drawn therefrom in light of the study, investigation and analysis of plaintiffs' counsel, accounting experts and other experts.

THE PARTIES

6. Plaintiffs David A. and Sylvia Lipton jointly purchased 3,000 shares of the common stock of Documation, Inc. in the open market on May 30, 1978 at an approximate aggregate price of $21 per share (excluding brokerage commissions).

7. Defendant Documation is a corporation organized and existing under the laws of the State of Delaware with its principal executive office located in Melbourne, Florida. Documentation, directly and through its subsidiaries or divisions,

designs, develops, manufactures and markets a variety of precision electro-mechanical computer products including high speed impact printers and sub-systems and high performance card readers and card punchers. On or about November 25, 1980, Documation merged with a subsidiary of Storage Technology Corporation ("STC") and became a wholly owned subsidiary of STC.

8. During the class period hereinafter referred to, Documation had issued and outstanding approximately 3 million shares of common stock (par value $.01) of which approximately 1,770,000 million shares were held by the public (other than defendants). Documation common shares were listed and traded on the American Stock Exchange during the class period prior to June 8, 1979, at which time said shares were listed and thereafter traded on the New York Stock Exchange. Documation issued and sold to the public (a) $15,000,000 principal amount of 11-1/2% Subordinated Debentures due 1998 pursuant to a prospectus dated May 10, 1978 ("11-1/2% Debentures") and (b) $25,000,000 principal amount of 12% Senior Subordinated Debentures due 1999 pursuant to a prospectus dated May 8, 1979 ("12% Debentures"). Both of the aforesaid classes of Debentures have been listed and traded on the American Stock Exchange during the class period.

9. The individual defendants were, during the class period, directors of Documation. In addition, the individual defendants held positions with Documation as indicated below next to their names.

S. Ray Halbert	Chairman of the Board, President, Chief Executive Officer and Treasurer throughout the class period
Robert S. Ames	Member of the Audit Committee until December 17, 1979
John H. Holcomb	Member of the Audit Committee throughout the class period

James F. Morgan	Member of the Audit Committee until about May, 1978
Richard J. Testa	Member of the Audit Committee during the fiscal year ending February 3, 1978 and until December 17, 1979

10. The individual defendants, as directors, officers and/or members of the Audit Committee had the responsibility for the active management of Documation and the power and duty to influence the policies and actions of Documation including the accounting and financial functions of Documation, and matters relating to the appointment and activities of its public auditors.

11. Throughout the class period, defendant S. Ray Halbert has owned approximately 463,000 shares (approximately 15%) of the outstanding common stock of Documation, and defendant Textron, Inc. ("Textron"), through the American Research and Development Division of Textron ("ARD"), owned approximately 812,000 shares (approximately 27%) of the outstanding common stock of Documation. They were, during the class period, the two largest shareholders of Documation.

12. Textron is a corporation duly organized and existing under the laws of the State of Delaware. Defendant Ames, at all times during the class period, was an Executive Vice President of Textron, and defendant Morgan was, during such period, Senior Vice President of Textron's subsidiary ARD. As a result of its substantial influence as a 27% stockholder of Documation, Textron has designated said individual defendants to serve on the Board of Directors of Documation and its Audit Committee. Said individual defendants have acted as directors and as Audit Committee members so as to further the financial interests of Textron and to protect the market value of Textron's stock interest in Documation, and Textron has encouraged and approved such actions taken by said defen-

dants and has not sought to correct the fraudulent acts and transactions complained herein of which it was aware and which inured to its benefit.

13. Defendant Peat Marwick Mitchell & Co. ("PMM") is a firm of certified public accountants which performed certain accounting and auditing services for Documation prior to and during the class period as referred to hereinafter. PMM's regional office, which was primarily responsible for accounting and auditing services to Documation, is located in Fort Lauderdale, Florida.

CLASS ACTION ALLEGATIONS

14. Plaintiffs bring this action on behalf of themselves and as a class action pursuant to Rule 23 of the Federal Rules of Civil Procedure on behalf of all other purchasers, similarly situated, of the common stock, 11-1/2% Debentures and 12% Debentures (hereinafter collectively called "securities") of Documation, (except the defendants herein), who purchased said securities during the period from May 1, 1978 through April 14, 1980 (the "class").

15. The members of the class number in the thousands and therefore exceed the number practicable for joinder.

16. Plaintiffs and the class have retained counsel experienced in litigation of this nature. Plaintiffs have the same interests as the class and their claims are typical of the claims of the members of the class and they will fairly and adequately protect the interest of the class.

17. Plaintiffs do not contemplate any difficulty in the management of this suit as a class action in this forum and a class action is superior to any other available means for the fair and efficient adjudication of the controversy herein. The common questions of law and fact predominate over any questions affecting only individual members. Some of the common questions of law and fact which predominate are: whether, during the class period the defendants (other than PMM) knowingly or recklessly inflated the revenue, income

and assets of Documation; whether PMM acted knowingly or recklessly in performing audits of the financial statements of Documation which failed to reveal the aforesaid inflated revenue, earnings and assets, and acted knowingly and recklessly in issuing false and misleading reports on the financial statements of Documation; whether the conduct of the defendants or some of them violated Sections 10(b) and/or 20(a) of the Exchange Act and state law; and whether the plaintiffs and the class suffered damages by reason of their purchases of Documation securities at prices inflated by defendants' wrongful conduct.

BACKGROUND FACTS RELATING TO DOCUMATION'S BUSINESS

18. Documation was founded in 1970 by defendant S. Ray Halbert. It first publicly issued common stock in 1976, and by 1977, it was growing rapidly based upon its technological innovations and aggresive marketing. It has at all times been subject to intense business competition and its success has depended to a large extent upon the sale of products which represent the most advanced technology available. Rapid obsolescence is a characteristic of the products developed, produced and marketed by Documation.

19. Documation has generally marketed its card handling products to Original Equipment Manufacturers ("OEM") for incorporation into data processing systems which they in turn market under their respective trade names. Documation has generally marketed its printer sub-systems to end-users. The products marketed to end-users have been by means of both short-term and long-term lease and for ultimate purchase. Documation also has had agreements with independent leasing firms pursuant to which it sells to them certain of its products which are on lease to end-user customers together with the rights under such leases. Such independent leasing companies are not obligated to purchase equipment and leases offered by Documentation and such goods are generally shipped subject to acceptance by such companies. Documation has had agreements with substantially all of its OEM customers which

generally provide for volume purchases over extended periods of time. However, such OEM customers are not obligated under said agreements to make any specific amounts of purchases and they have rights to cancel items (subject to certain penalties in the form of loss of quantity discounts on items previously purchased) even after purchase orders are given and goods are shipped.

20. During most of the class period, Documation, with the concurrence and approval of its public auditors, PMM, purported to apply certain principles in the recognition of revenues from certain of its marketing operations. Revenue derived from marketing products was recognized, net of an estimated allowance for returns during normal evaluation periods, in accordance with the following policies, among others:

Revenue was recognized

(a) at time of shipment, if products subject to noncancellable lease agreements were sold to independent leasing companies; and

(b) at time of shipment, if products were shipped subject to noncancellable lease agreements classified as sales-type leases.

COUNT I

[AGAINST ALL DEFENDANTS OTHER THAN PMM FOR VIOLATION OF SECTION 10(b) OF THE EXCHANGE ACT AND RULE 10b-5 THEREUNDER AND STATE LAW]

21. Plaintiffs repeat and reallege paragraphs 1 through 20 as though fully set forth herein.

22. During the class period, Documation and the individual defendants, knowingly or recklessly caused, participated in or approved a common course of conduct, as more fully set forth below, which conduct included acts and practices which operated as a fraud upon the plaintiffs and other members of the class and included various untrue statements of material facts and/or statements which omitted to state material facts neces-

sary in order to make the statements made, in light of the circumstances under which they were made, not misleading, to the plaintiffs and other members of the class. The purpose and effect of such common course of conduct was to maintain the market price of Documation securities at an artificially high level and to cause the plaintiffs and other members of the class to purchase Documation securities for an excessive consideration during the class period.

23. During the class period, said defendants, pursuant to said common course of conduct, as more fully set forth below, knowingly or recklessly issued, caused to be issued, participated in the issuance of, or approved the issuance of false and misleading statements to the investing public which were contained in various documents, such as annual reports, prospectuses, and quarterly reports, including those documents referred to in paragraphs 24 through 32 below, and failed to disclose material facts to the investing public with respect to, among other things:

A. The fact that Documation's reported sales revenues and accounts receivable were grossly inflated throughout the class period.

B. The fact that Documation's reported inventory for at least the first three quarters of its 1979 fiscal year (ending February 1, 1980) was grossly inflated.

C. The fact that its ability to survive as a going concern was severely jeopardized by reckless over-expansion, resulting in sharply increased expenses, a large build-up of obsolescent inventory, a negative cash flow and possible defaults in a major bank loan agreement, all of which occurred during the 1979 fiscal year.

24. In its Annual Report to shareholders for the 1977 fiscal year (ending February 3, 1978), Documation presented a false and misleading picture of its growth and prospects. In said Report, it reported total revenues of $31.5 million, an increase of 70% over the prior fiscal year, and net earnings of $3.6 million, an increase of 81% over the prior fiscal year. In the

"letter to shareholders" section of said Annual Report (at page 3), defendant S. Ray Halbert stated that "Documation is positioned to move forward from our present base and meet the challenges that lie ahead" and made other similar statements proclaiming Documation's technical and marketing achievements and steps taken to "sustain our growth". In the "Summary of Significant Accounting Policies" at page 17 of said Annual Report, Documation described the accounting principles it purported to apply with respect to revenue recognition, including the principles described in paragraph 20 hereinabove, and further stated that "The accounting policies employed by the Company are consistent with generally accepted accounting principles. In those instances in which more than one generally accepted accounting principle can be applied, the Company has adopted the accounting principle that it believes most accurately and fairly reflects the situation". Said Annual Report contained audited financial statements and notes thereto including a consolidated balance sheet for fiscal years 1977 and 1978, consolidated statements of income and of changes in financial positions for said periods and a consolidated statement of stockholders' equity.

25. The aforesaid statements and financial information contained in the 1977 Annual Report (for the 1977 fiscal year ending February 3, 1978) were false and misleading and said Annual Report failed to disclose material facts as follows:

A. The reported net earnings for the 1977 fiscal year were overstated by at least 55% or approximately $2,013,000, said overstatement resulting from a grossly inadequate loss reserve and provision of only $1,036,000, instead of at least $3,049,000, for the allowance for losses on sales returns and uncollectible receivables.

B. The accounts receivable of Documation in its year-end balance sheet for the fiscal year 1977 (appearing at pages 20-21) were overstated by at least $2,013,000 (or 16%) for the aforesaid reason, thereby inflating Documation's reported working capital, retained earnings and net worth.

C. The statement on page 17 of said Report that revenue recognition was, where applicable, "net of an estimated allowance for returns during normal evaluation periods" was false and misleading in that it failed to reveal the fact that the estimates used were grossly understated and untrustworthy.

D. The statement on Page 17 of said Report that Documation's accounting policies were "consistent with generally accepted accounting principles" and "most accurately reflects the situation" was false and misleading in that it failed to reveal the fact that the stated policies of revenue recognition were not being carried out because the estimated allowance for losses on sales returns and uncollectible receivables was grossly understated in those categories where revenues were recognized at time of shipment for sales-type leases and for sales to independent leasing companies of equipment subject to non-cancellable leases.

E. Said Annual Report failed to disclose that Documation's rapid development programs and high rate of sales returns had resulted in the accumulation of a large inventory which was subject to early obsolescence.

F. Said Annual Report failed to disclose that, during the 1977 fiscal year, Documation was experiencing substantial customer refusals to accept products shipped pursuant to cancellable orders, or shipped subject to customer acceptance, and that such experience had not been taken into account in determining the reasonable reserves needed for losses on sales returns and uncollectible receivables and in determining the provision for allowance for losses on sales returns and uncollectible receivables set forth in Documation's financial statements.

26. The aforementioned Documation financial statements and notes thereto for the 1977 fiscal year and the accounting policy and revenue recognition statements referred to above

(paragraphs 20 and 24, *supra*) were contained in Documation's Form 10-K report for the 1977 fiscal year filed with the Securities Exchange Commission ("SEC"), its unaudited quarterly interim financial statements for the first three fiscal quarters of the 1977 fiscal year were contained in Form 10-Q reports filed with the SEC, and its comparative quarterly revenues and earnings for the fiscal years 1976 and 1977 were reported in press releases issued during 1977. The prospectus and registration statement covering the issuance of its 11-1/2% Debentures contained audited financial statements for the 1977 fiscal year and the aforementioned accounting policy and revenue recognition statements. All of said documents were false and misleading and omitted to state the material facts referred to in paragraph 25 above.

27. In its 1978 Annual Report (covering the 1978 fiscal year ending February 2, 1979), Documation reported consolidated revenues of approximately $58.7 million, an increase of 86% over the 1977 fiscal year and net income of approximately $6.4 million, an increase of 74% over the prior year. The "letter to shareholders" at page 1 continued to emphasize the growth and technological achievements of Documation and optimistically spoke of "new dimensions for the future". Said Annual Report contained audited financial statements which set forth Documation's financial results, consolidated balance sheet position and change in financial position and statement of shareholders' equity for fiscal years 1977 and 1978. As in the previous Annual Report, it also contained, at page 17, a similar statement under "Summary of Significant Accounting Policies" and a similar description of its purported revenue recognition policies.

28. The aforesaid statements and financial information contained in the 1978 Annual Report (for the fiscal year ending February 2, 1979) were false and misleading and said Annual Report failed to disclose material facts as follows:

A. The reported favorable net earnings for the 1978 fiscal year were overstated by at least 21% or approximately $1,358,000, said overstatement resulting from a

grossly inadequate loss reserve and provision of only $1,157,000, instead of at least $2,515,000, for the total allowances for losses on sales returns and uncollectible receivables.

B. The accounts receivable of Documation in its year-end balance sheet for the fiscal year 1978 (appearing at pages 20-21) were overstated by at least $1,358,000 for the aforesaid reason.

C. The aforementioned statements contained at page 17 were false and misleading for the substantially same reasons as those referred to in paragraphs 25C and 25D.

D. Said Annual Report failed to disclose that Documation's rapid development programs and a high rate of sales returns had resulted in the accumulation of a large inventory which was subject to early obsolescence.

E. Said Annual Report failed to disclose that Documation was experiencing, in the 1978 fiscal year, substantial refusals by customers to accept products shipped pursuant to cancellable orders, or shipped subject to customer acceptance, and that such experience had not been taken into account in determining the reasonable reserves needed for losses on sales returns and uncollectible receivables and in determining the provision for allowances for losses on sales returns and uncollectible receivables set forth in Documation's financial statements.

29. The aforementioned Documation audited financial statements for the 1978 fiscal year and notes thereto, and the accounting policy and revenue recognition statements referred to in paragraph 27, were contained in Documation's Form 10-K for the 1978 fiscal year and in a registration statement and prospectus dated May 8, 1979 covering the issuance of its 12% Debentures, both of which were filed with the SEC. These reports as well as Documation's three interim unaudited quarterly Form 10-Q reports for the first three quarters of the 1978 fiscal year filed with the SEC and press releases in 1978 covering comparative quarterly revenues and earnings for the

1977 and 1978 fiscal years were false and misleading and omitted to state the material facts referred to in paragraph 28 above.

30. During the 1979 fiscal year (ending February 1, 1980), Documation experienced undisclosed adverse effects resulting from inflation, rising interest rates, over-expansion of production and marketing organization and facilities, and a continued high rate of sales returns, all of which contributed to a rapid increase in expenses and to a rapid build-up in inventory which could not readily be sold and which was subject to early obsolescence. By the end of the 1979 fiscal year, obsolescent and unsaleable inventory was improperly carried on Documation's books at approximately $4.15 million.

31. Documation's quarterly reports on form 10-Q for the first and second quarters for the 1979 fiscal year filed with the SEC showed dramatically increased revenues and earnings compared with similar quarterly periods in the prior fiscal year. Such comparative revenues and earnings were also contained in its press releases issued in 1979. Documation's reported revenues for the quarter ending April 27, 1979 had increased to approximately $19.8 million as compared with $11.1 million for first quarter of fiscal 1978 and net income had increased to $1,827,740 from $1,188,634 for the similar period in fiscal 1978. The reported revenues for the second quarter of the 1979 fiscal year (ending August 17, 1979) were about $28 million as compared with about $16 million for the period in the prior year. Net earnings in the second quarter for 1979 fiscal year were reported as being slightly down as compared with the prior year. Said financial information was false and misleading and said reports and releases failed to disclose material information as follows:

> A. The reported net earnings in the first quarter of the 1979 fiscal year were overstated by approximately $1,202,000 and the reported net earnings in the second quarter of the 1979 fiscal year were overstated by approximately $1,306,000. Said overstatements resulted from a

grossly inadequate loss reserve and provision for allowance for losses on sales returns and uncollectible receivables.

B. The inventory, which was stated to be valued at the lower of cost or market in each of said Form 10-Q reports for the first and second fiscal quarters of the 1974 fiscal year, was grossly inflated by reason of a large build up of inventory and returned inventory all of which was subject to early obsolescence and could not reasonably be expected to be sold or "resold". Said inventory required enormous writedowns, a procedure which Documation improperly failed to do.

C. The notes to the consolidated condensed financial statements contained in said Form 10-Q reports for each of the first two fiscal quarters of the 1979 fiscal year misrepresented that said financial statements reflected all adjustments (consisting only of normal recurring adjustments) necessary to a fair statement of Documation's financial position, results and changes in financial position, and falsely implied that no "extraordinary" charges were necessary to a fair statement.

D. The aforesaid 10-Q reports for the 1979 fiscal year were grossly false and misleading since Documation would have reported a substantial net loss instead of the reported net gain of $3,326,355 ($1.09 per share) for the first half of the 1979 fiscal year if a proper loss provision for allowance for losses on sales returns and uncollectible receivables and a proper inventory valuation had been applied.

32. In its Form 10-Q report for the third quarter (ending November 9, 1979) filed with the SEC and in a press release covering said quarter of fiscal 1979, Documation reported a net loss of approximately $2.7 million and remained profitable through the first three quarters. Said financial information was false and misleading and said report and release failed to disclose material information as follows:

A. Said 10-Q report and release understated net losses by approximately $375,000 ($.12 per share), said understatement being due to an inadequate provision for allowance for losses on sales returns. Accounts receivable (and working capital) were overstated in said report by approximately $375,000 due to said under-allowance for returns on sales and grossly inadequate provision for such losses on the balance sheet.

B. In addition, the third quarter results showing reduced revenues and earnings were grossly understated because Documation's inventory was substantially overvalued and required enormous writedowns, a procedure which Documation improperly failed to do.

C. The notes to the consolidated in condensed financial statements contained said 10-Q report were false and misleading for substantially similar reasons as those referred to in paragraph 31C.

D. Said 10-Q report failed to reveal the fact that defaults in bank credit agreements would occur if the adverse operating results continued in the last quarter of the fiscal year.

E. Said 10-Q report failed to reveal the fact that it was experiencing and would continue to experience negative cash flow which would soon jeopardize its ability to survive as a going concern.

33. During the latter part of the 1979 fiscal year (ending February 1, 1980), Documation committed, or was dangerously near to committing, specific events of default with respect to its unsecured bank undebtedness under its revolving credit agreement with a lending bank. Said indebtedness was $29,000,000 at the 1979 fiscal year-end. Said events of default could have accelerated the due date (July 31, 1981) of the full amount of said loan. Said defaults or possible defaults, and the possible disasterous effects thereof, were not disclosed to the investing public during the class period.

34. On or about April 14, 1980, Documation released its financial results for the 1979 fiscal year which appeared in the Wall Street Journal on April 15, 1980. Documation reported a financial debacle. It stated that it had suffered a net loss of $9.5 million ($3.12 per share) and that more than half of said loss was due to writedowns of inventory and accounts receivable. This loss compares with reported net earnings of $6.4 million or $2.11 per share in the prior fiscal year. It reported that it had a net loss of $10.1 million in the fourth quarter alone, compared with reported net income of $1.8 million for that quarter in the previous year. It stated that defendant Testa had become Chairman of the Board (replacing defendant Halbert) and quoted Mr. Testa's statement that "It is unlikely at least in the first half of the current (1980) fiscal year, that there will be much good news as far as our bottom line is concerned". Documation's net loss for the 1979 fiscal year, staggering though it was, was understated by at least 20% as a result of the continued use of a grossly inadequate reserve and provision for allowance on losses on sales returns.

35. Thereafter, in its 1979 Annual Report for the fiscal year ending February 1, 1980, Documation more specifically revealed that the extraordinary loss in the fourth fiscal quarter of 1979 included writedowns of inventory of $4.15 million and writedowns of accounts receivables of $1.15 million or a total loss of $5.3 million or $1.75 per share. Documation further stated that "allocation of the year-end adjustments to specific quarters within the fiscal year is not practicable".

36. As of February 2, 1980, Documation, with the concurrence and approval of new auditors after the termination of the accounting services of PMM, corrected its revenue recognition accounting practices applicable to the 1980 fiscal year ending February, 1981 to ensure that the recognition of revenue would match the completion of the earning process. Thus, Documation began recognizing revenue upon customer acceptance (rather than upon shipment) for sales-type leases, and for sales to independent leasing companies of equipment subject to non-concellable leases. The difference between the old ac-

counting method (which had improperly utilized a grossly inadequate provision for allowance for losses on sales returns and uncollectible receivables) and the new method aggregated $5,808,000. Documation recorded a retroactive $5,808,000 charge against retained earnings for the first quarter of the 1980 fiscal year, and restated its yearly earnings results (pro-forma) for the 1977, 1978 and 1979 fiscal years.

37. With respect to Documation's inventory and accounts receivable writedowns totalling $5.3 million, Documation has publicly stated the impracticability of restating its three 1979 fiscal year quarterly interim reports. Plaintiffs therefore cannot precisely determine by fiscal quarter the overstatement of income due to improper revenue recognition or the failure to writedown inventory on a timely basis. However, had proper accounting practices been utilized, it is clear that there would have been a material reduction or virtual elimination of the $3,326,355 of net profit reported in the first two quarters of fiscal 1979, and substantially greater losses than that reported in the third quarter.

38. The enormous fourth quarter writedown for the 1979 fiscal year relating to over-valued inventory and accounts receivable ($5,300,000) plus the unusually large retroactive writedown of retained earnings in the first quarter of the 1980 fiscal year reflecting the differential between the improperly applied old accounting method and new accounting method of reporting revenue ($5,808,000) wiped out all reported earnings for the past three fiscal years. The gross impropriety in the application of the old accounting method of revenue recognition is confirmed by, among other things, the fact that, as indicated by the $5,808,000 retroactive loss, reported earnings for the 1977, 1978 and 1979 fiscal years had grossly distorted Documation's actual sales and therefore presented Documation's sales picture in a grossly false and misleading way. As previously indicated, the magnitude of the distortion of net earnings from the improper application of the revenue recognition policies of Documation ranged from as much as 55% to 21% during fiscal years 1977, 1978 and 1979, and resulted

from the grossly inadequate loss reserve and provision for allowance for losses on sales returns and uncollectible receivables. Similarly, the enormous size of the inventory writedown in the last quarter of the 1979 fiscal year and Documation's implicit acknowledgement that this loss also has reference to the three prior fiscal quarters of 1979 (*supra* para. 35), confirms that grossly improper inventory valuation principles had been applied in at least the first three quarters of the 1979 fiscal year.

39. As a result of the April 14, 1980 disclosures of the substantial losses reported in the fourth quarter and for the 1979 fiscal year, and the disclosures concerning substantial writedowns taken by Documation as described above, and the above-quoted statement by Documation that further losses were anticipated, the price of Documation's securities sharply declined. Thus, Documation's common stock declined from a price on April 11, 1980 of 8-5/8 to a price on April 15, 1980, the next trading date, of 7-1/8, a decline of 1-1/2 per share. The 11-1/2% Subordinated Debentures declined 2 points, from 52 to 50, for the same dates and the 12% Subordinated Debentures declined 7 points from 60 to 53.

40. Documation's audited financial statements and its auditor's (PMM's) report thereon for the 1979 fiscal year ending February 1, 1980 revealed that Documation's balance sheet for the first time carried the aforementioned $29 million revolving bank loan as a current liability instead of a long-term liability. PMM's report, dated April 14, 1980 except as to Note 3 which is as of May 1, 1980, to the Board of Directors and stockholders with respect to Documation's audited consolidated financial statements for the 1979 fiscal year, and Note 3 to said consolidated financial statements, stated that this indebtedness had been reclassified because the bank could accelerate the due date of said loan but had temporarily waived specific events of default and was seeking a security interest in the assets of Documation.

41. On May 6, 1980, Documation and its Audit Committee terminated the services of PMM and failed to disclose the

reason for the termination. However, it did disclose that in connection with the preparation of the interim report for the third quarter (ending November 9, 1979) of its 1979 fiscal year ending February 3, 1980, a disagreement between PMM and the Documation Board of Directors and Audit Committee had arisen as to the recording of revenues. The disagreement was resolved in favor of PMM.

42. Documation has disclosed that the Securities Exchange Commission has been investigating its previous reporting practices as they relate to the federal securities laws.

43. Documation's critically weakened financial condition as disclosed by the 1979 fiscal year results was such that (a) it was unable to make its November 1, 1980 semi-annual interest payments (about $2.5 million) on its outstanding 11-1/2% and 12% Debentures without the help of an outside guarantor; (b) the bank's unsecured revolving loan, which had grown to $36,500,000 shortly after the end of the 1979 fiscal year, was converted in July 1980 into a debt secured by the assets of Documation; and (c) in the fall of 1980, Documation's attorneys acknowledged in this litigation that Documation's financial position continued to be so severe that there was substantial doubt that it could survive unless it merged with STC. That Documation faced a severe threat to its survival as a going concern was not publicly revealed during the class period.

44. By reason of the foregoing, defendants herein knew or recklessly ignored generally accepted principles of accounting including, among others:

(a) the principles of adequate disclosure and reliability of financial statements as set forth in Statement No. 4 of Accounting Principles Board ("Statement No. 4"), paragraphs 106 and 108;

(b) the principle that a conservative approach providing early recognition of unfavorable events and minimizing the amount of net assets and income reported should be employed as set forth in Statement No. 4, paragraph 44;

(c) the principle that methods of measuring and reporting should be adopted which are most likely to aid readers in making the types of economic decisions for which they typically employed financial accounting data as set forth in Statement No. 4, paragraph 88;

(d) the principles dealing with revenue realization, including the principle that revenue is generally recognized when the earning process is complete as set forth in Statement No. 4, paragraph 150 and Accounting Research Bulletin No. 43 Ch. 1 Section A; and the principle that revenue in a period should be matched with the expenses of that period as set forth in Slavin and Reynolds, *Basic Accounting* (3rd ed.) page 128.

(e) the principles dealing with Accounting for Leases as set forth in FASB Statement No. 13, including paragraphs 6 and 7 and in particular the principle that in sales-type leases, collectibility of minimum lease payments should be reasonably predictable.

(f) the principles dealing with inventory pricing and in particular Chapter 4 of Accounting Research Bulletin No. 43;

(g) the principles dealing with the preparation of interim reports, including the principle that interim reports should contain the same practices and procedures that apply to annual reports as set forth in Accounting Principles Board Opinion No. 28, paragraphs 9 and 10.

(h) the principles dealing with the appropriateness of preparation of financial statements on a going concern basis including SAS No. 2, paragraphs 21-26, 35, 39 and 45; *Montgomery's, Auditing* (9th ed.), Chapter 2, pages 50-51; and SEC Release No. 5049 (Accounting Series No. 115) (1970).

(i) the principle that notes to financial statements should disclose all additional information necessary for a fair presentation as set forth in Accounting Principles Board No. 4, paragraph 199.

45. As part of the merger of Documention with STC, Documation agreed to place approximately $8 million worth of STC stock, issued by STC as part of the merger consideration to Documation's shareholders, into an escrow fund to cover certain contingent undisclosed liabilities of Documation. Said escrow fund covers the instant class action for damages, certain potential litigation, the SEC investigation previously referred to in paragraph 41 above and any undisclosed breach of the merger agreements.

46. By reason of the foregoing, defendants herein knew or recklessly disregarded the fact that the statements and reports referred to in paragraphs 23 through 32 were false and misleading as alleged therein and that there were material facts required by law to be stated and necessary to make the statements and reports made not misleading as alleged in paragraphs 23 through 40 and 43.

47. All of the defendants herein knew or recklessly disregarded the fact that the aforesaid acts and practices, misleading statements and omissions would adversely effect the integrity of the market in Documation securities and artificially inflate or maintain the prices of such securities.

48. (a) By reason of the foregoing, defendants directly and indirectly, by the use of the mails and means of instrumentalities of transportation and communication in interstate commerce, have violated Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder in that, with scienter, they (i) employed devices, schemes and artifices to defraud, (ii) made untrue statements of material facts or omitted to state material facts necessary in order to make statements made, in light of the circumstances under which they were made, not misleading, or (iii) engaged in acts, practices and a course of business which operated as a fraud or deceit upon plaintiffs and other members of the class in connection with their purchases of Documation securities during the class period.

(b) At all times during the class period, defendant Textron has controlled defendants Ames and Morgan within the mean-

ing of Section 20 of the Exchange Act and directly and/or indirectly induced the wrongful conduct of said individual defendants for Textron's benefit.

49. As a result of the dissemination of false and misleading information and the failure to disclose material facts, as set forth above, the market prices of Documation securities were artificially inflated during the class period. In ignorance of the false and misleading nature of the representations described above and in the absence of the material information which the defendants failed to disclose, as described above, plaintiffs and other members of the class relied, to their damage, on the integrity of the market prices of Documation securities during the class period in purchasing their Documation securities. At the time of the purchases by plaintiffs and the class of said securities, the fair market value of said securities was substantially less than the prices paid by them.

50. The prices of Documation securities declined sharply upon the public disclosure of the facts which had been misrepresented or concealed as alleged herein. Plaintiffs and other members of the class have suffered substantial damages as a result of their purchases of Documation stock at prices which were inflated by the wrongful conduct of defendants.

COUNT II

[AGAINST PMM FOR VIOLATION OF SECTION 10(b) OF THE EXCHANGE ACT AND RULE 10b-5 PROMULGATED THEREUNDER]

51. Plaintiffs repeat and reallege paragraphs 1 through 20, 22 through 48(a) and 50 as if fully set forth herein.

52. During the class period, PMM served as the independent Certified Public Accountants to Documation and provided various financial and accounting services and certified various financial statements of Documation. The aforementioned 1978 and 1979 prospectuses and the annual reports for the 1977 and 1978 fiscal years included audited year-end financial statements

covering the fiscal years 1977 and 1978, examined by PMM, and included PMM's financial reports thereon to the Board of Directors and stockholders of Documation. Such reports stated that PMM's examination was in accordance with generally accepted auditing standards and that said financial statements set forth Documation's financial position, results of operations, and changes in financial position fairly in conformity with generally accepted accounting principles applied on a consistent basis. The dates of its reports were March 30, 1978, and March 16, 1979. However, PMM knew or recklessly disregarded facts known to it showing that such statements in its reports were false and that said financial statements did not set forth Documation's financial position, its results of operations and changes in financial position in accordance with the requirements of generally accepted accounting principles or principles of fair reporting and that its audits for the 1977 and 1978 fiscal years did not conform to generally accepted auditing standards, accounting principles or principles of fair reporting, in at least the following respects:

(a) PMM was required by generally accepted auditing standards to seek to ascertain whether in fact Documation complied with generally accepted accounting principles and fair reporting in presenting its financial position. In its audit of Documation, PMM reviewed material concerning, among other matters, the existence or nonexistence of material uncertainties regarding the propriety and adequacy of reserves, valuation of inventory, ability to maintain and comply with credit arrangements, the proper determination of income, experience and projections as to revenues and profits and losses experienced and anticipated on sales returns and accounts receivable. Said audit review relating to Documation's inventory valuation and loss reserves for sales returns and uncollectible receivables was fraudulently or recklessly performed.

(b) As a result of its audits, PMM knew and/or recklessly disregarded that, as alleged in paragraphs 23

through 43 above, the statements of Documation's revenues, earnings, assets, retained earnings and net worth were false and misleading. Nevertheless PMM failed to disclose such facts in its reports, and was required to issue qualified or adverse opinions, which it improperly failed to do.

53. PMM, acting as auditors of Documation knew or recklessly disregarded the fact that Documation's financial statements for the fiscal 1977 and 1978 years were presented in a manner which violated, among others, the generally accepted accounting principles set forth above in paragraph 44 above. In addition, PMM knew or recklessly disregarded that Documation's said financial statements had not been examined in accordance with generally accepted auditing standards in that the following auditing and reporting standards, among others, were violated:

—AICPA General Standard No. 3 was violated, which standard requires that due professional care is to be exercised in the performance of the examination and in the preparation of the report.

—AICPA Standard of Field Work No. 2 which requires a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be limited.

—AICPA Standard of Field Work No. 3 was violated, which standard requires that sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

—AICPA Standard of Reporting No. 3 was violated, which standard requires that informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

54. PMM knew that the aforementioned audited financial statements of Documation and PMM's reports thereon coverings Documation's 1977 and 1978 fiscal years would be issued to holders of Documation securities and to the investing public and that the information in the financial statements, and in PMM's reports thereon, would influence the market prices of Documation securities, and that prospective purchasers of Documation securities would rely upon the integrity of the market in deciding whether to purchase such securities.

55. At the time they purchased their Documation securities, plaintiffs and other members of the class did not know and had no reason to believe, that the aforesaid financial statements and PMM's reports thereon contained untrue statements of material facts or material omissions.

56. By reason of the dissemination of the audited financial statements contained in the said annual reports and in said prospectuses covering fiscal years 1977 and 1978 which were issued to the investing public, with PMM's participation or approval and unqualified opinions as set forth in its reports on said financial statements, PMM manipulated and inflated the market price of Documation's securities. As a result thereof, plaintiffs and the class purchased securities of Documation at prices inflated by said false and misleading financial statements and by PMM's reports thereon.

57. Plaintiffs and the class relied upon the absence of material adverse information about Documation, and the integrity of the market in making their purchases of Documation securities. If the true financial and operating position of Documation had been disclosed in the financial statements contained in said reports, plaintiffs and the class would not have purchased said securities at the prices which they paid; at the time of the purchases by plaintiffs and the class of said securities, the fair market value of said securities was substantially less than the prices paid by them.

COUNT III

[AGAINST ALL DEFENDANTS FOR FRAUD AND DECEIT]

58. Plaintiffs repeat and reallege paragraphs 1 through 20, 22 through 50 and 52 through 57 above as if fully set forth herein.

59. Jurisdiction of this Count is based upon principles of pendent jurisdiction.

60. For the purpose of inducing public investors, including plaintiffs and other members of the class to purchase Documation securities, with intent to deceive said investors, the defendants made and participated in the making of misrepresentations of fact to plaintiffs and other members of the class as set forth in paragraphs 23 through 40 above and concealed material facts, as set forth in paragraphs 23 through 50, and 52 through 53, above.

61. Said representations were not true. Defendants did not believe them to be true.

62. Plaintiffs and other members of the class were ignorant of the true situation at the time of said representations and omissions but believed them to be true. In reliance upon said misrepresentations, in ignorance of the undisclosed facts, and in reliance on the fidelity, integrity and superior knowledge of defendants, plaintiffs and other members of the class were induced to and did purchase Documation securities. Had plaintiffs and other members of the class known such facts, they would have taken no such action. By reason thereof, plaintiffs and other members of the class have been damaged.

COUNT IV

[AGAINST ALL DEFENDANTS FOR GROSS NEGLIGENCE OR NEGLIGENCE]

63. Plaintiffs repeat and reallege paragraphs 1 through 20, 22 through 50 and 52 through 57 above as if fully set forth herein.

64. Jurisdiction of this Count is based upon principles of pendent jurisdiction.

65. Defendants made and participated in the making of representations of fact to plaintiffs and other members of the class by means of various documents and failed to disclose material facts as set forth in paragraphs 23 through 50 and 52 through 53 above.

66. Said representations were not true. Defendants were without reasonable grounds for believing them to be true.

67. Further, in making said representations, as alleged hereinabove, defendants omitted to state material facts, as alleged hereinabove, necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading and which were necessary to be stated in order that investors and prospective investors in Documation securities would be informed of all the material facts necessary for an investment decision. Among the direct and proximate causes of said omissions to state material facts was the gross negligence, or negligence and carelessness, of the defendants.

68. Plaintiffs and other members of the class were ignorant of the true situation at the time of said misrepresentations and omissions but believed them to be true. In reliance on said misrepresentations, in ignorance of the undisclosed facts, and in reliance upon the superior knowledge and expertise of defendants, plaintiffs and other members of the class were induced to, and did purchase Documation securities at inflated prices. Had plaintiff and other members of the class known the undisclosed facts, they would not have taken such action. By reason thereof, they have been damaged.

WHEREFORE, plaintiffs demand judgment as to Counts I, II, III and IV:

1. Against each defendant and in favor of the plaintiffs and all members of the class sued for herein for damages in an amount determined to be sustained by plaintiffs and said class members, together with interest thereon;

2. Against each defendant for punitive damages as to Counts III and IV only;

3. That plaintiffs be allowed the costs and expenses of this action, including reasonable attorneys', accountants' and experts' fees and

4. Such other and further relief as may be just and proper.

DATED: January 30, 1981

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No. 84-646 (3)
No. 84-651 (2)

IN THE

Supreme Court of the United States

OCTOBER TERM, 1984

PEAT, MARWICK, MITCHELL & CO.,
Petitioner,

v.

DAVID A. and SYLVIA S. LIPTON,
Respondents.

DOCUMATION, INC., S. RAY HALBERT, RICHARD J. TESTA, ROBERT S. AMES, JOHN H. HOLCOMB, JR., JAMES F. MORGAN and TEXTRON, INC.,
Petitioners,

v.

DAVID A. and SYLVIA S. LIPTON,
Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

CONSOLIDATED BRIEF FOR DAVID A. and SYLVIA S. LIPTON IN OPPOSITION

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Questions Presented

The question certified for interlocutory review by the district court pursuant to 28 U.S.C. §1292(b) and answered in the affirmative by the court of appeals was:

> Whether a complaint seeking damages for alleged violations of Section 10(b) of the Securities Exchange Act of 1934 [15 U.S.C. §78j(b)] and Securities and Exchange Commission Rule 10b-5 states a claim upon which relief can be granted when the complaint, asserting a "fraud on the market" theory, alleges merely that plaintiff purchased securities relying "on the integrity of the market prices" of those securities and that because of the misrepresentations and omissions alleged, "the market prices of . . . [the] securities were artificially inflated," and there is no allegation that the securities would not have been marketed at all but for the misrepresentations and omissions complained of.

Petitioners in Nos. 84-646 and 84-651 have incorrectly stated the certified question, adding to it the phrase "when plaintiffs admit they did not read or rely upon the allegedly misleading documents." This is pure invention. On this interlocutory appeal from denial of the motion to dismiss, with no discovery having been taken, there is no factual record and no such admission.

Petitioner in No. 84-646 (Peat, Marwick, Mitchell & Co.) presents a second question not presented to the lower courts and further removed from the very limited record in this case. It claims, again in the absence of any factual record whatsoever, that the auditor's only involvement was peripheral, that it acted independently and without wrongful in-

tent, and that "plaintiff was wholly unaware of the auditor's existence, much less his opinion concerning the issuer's financial statement."

Petitioners' "emendation" of the certified question and their assertion of non-existent facts point to the inappropriateness of review in the absence of a factual record beyond the pleadings.

TABLE OF CONTENTS

Table of Authorities

Cases: PAGE

In the

Supreme Court of the United States

October Term, 1984

No. 84-646

Peat, Marwick, Mitchell & Co.,

Petitioner.

v.

David A. and Sylvia S. Lipton,

Respondents.

No. 84-651

Documation, Inc., S. Ray Halbert, Richard J. Testa, Robert S. Ames, John H. Holcomb, Jr., James F. Morgan and Textron, Inc.,

Petitioners.

v.

David A. and Sylvia S. Lipton,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

CONSOLIDATED BRIEF FOR DAVID A. and SYLVIA S. LIPTON IN OPPOSITION

Petition No. 84-646 and Petition No. 84-651 both seek review of the decision on interlocutory appeal of the United States Court of Appeals for the Eleventh Circuit reported at 734 F.2d 740. David A. and Sylvia S. Lipton are named

as respondents by all petitioners and file this consolidated brief in opposition to both petitions.[1]

Statement

Plaintiffs-respondents purchased 3,000 shares of the common stock of defendant-petitioner Documation, Inc. ("Documation") on the open market (the American Stock Exchange) on May 30, 1978, at a cost of approximately $63,000.

In their Amended and Supplemental Class Action Complaint ("Complaint"), dated January 30, 1981, plaintiffs allege as follows:

In the period between May 1, 1978 and April 14, 1980, Documation reported substantial and increasing revenues and earnings. Virtually all these earnings were sham. In its public reports issued in this period there had been no disclosure of serious and growing financial problems, including a negative cash flow and possible imminent defaults on a major bank loan agreement. Instead, by means of accounting machinations a glowing financial picture was presented. These machinations included the use of an improper and grossly inadequate loss reserve for sales returns and uncollected receivables, and the failure to write down massive obsolete inventory.

On April 14, 1980, after the Securities and Exchange Commission had begun an investigation, Documation revealed that it had suffered a staggering net loss for the 1980 fiscal year, more than half of which was due to ex-

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[1] After Documation, Inc. and the individual defendants petitioned this Court for certiorari in No. 84-651, Documation, Inc. filed a Petition under Chapter 11 of The Bankruptcy Code, 11 U.S.C. §101 *et seq.* Respondents' Brief in Opposition is therefore not directed to Petitioner Documation, Inc. itself. 11 U.S.C. §362.

traordinary write-downs of inventory and accounts receivable. Further amounts were charged off to reflect properly the actual earnings of Documation in prior periods. The effect of the 1980 write-downs of over-valued inventory and accounts receivable, together with the write-down of retained earnings to reflect the adoption of a new accounting method of reporting revenue, wiped out all reported earnings for the prior three years.

Documation and its management (Petitioners in No. 84-651) pursued a common course of conduct designed to maintain an artificially high market price for Documation stock, and with wrongful intent disseminated false and misleading financial reports and releases and failed to disclose material adverse facts. As a direct result of this fraudulent conduct, plaintiffs paid prices for securities substantially greater than their fair market value and suffered substantial damages. When the true factual situation was disclosed, the market prices significantly declined in consequence. Plaintiffs relied upon the integrity of the market in making their purchases of Documation's securities. Plaintiffs informed the court below that they were able to plead direct reliance on documents referred to in the complaint, but argued successfully that reliance on the integrity of a developed market for securities fully met their burden in pleading.

Peat, Marwick, Mitchell & Co. ("PMM"), Documation's independent Certified Public Accountants in the relevant period, audited and reported on certain Documation financial reports contained in documents publicly disseminated. PMM's reports of March 30, 1978 and March 16, 1979, stating that its examination was in accordance with generally accepted auditing standards and that Documation's financial position was fairly set forth in conformity with generally accepted accounting principles applied on a con-

sistent basis, were false. PMM knew or recklessly disregarded the material adverse facts concerning Documation's revenues, earnings, assets, retained earnings and net worth. While alleging that PMM knew that its reports on Documation would influence the public market price of Documation securities and alleging reliance on the integrity of the market in making plaintiffs' purchase, the Complaint also specifically alleges as against PMM that plaintiffs "relied upon the absence of material adverse information about Documation" (¶57) and "did not know and had no reason to believe, that the . . . financial statements and PMM's reports thereon contained untrue statements of material facts or material omissions" (¶55).

Proceedings Below

Petitioners-defendants moved in the district court to dismiss the Complaint for failure to allege fraud with the required particularity and for failure to state a claim upon which relief could be granted (Rules 9(b) and 12(b)(6) of the Federal Rules of Civil Procedure). Following denial of the motions, defendants filed answers and plaintiffs moved for class certification. PMM also moved for certification, pursuant to 28 U.S.C. §1292(b), of the district court's ruling that the allegations of reliance on the integrity of the market were sufficient and that plaintiffs need not plead direct reliance. The district court granted §1292(b) certification and simultaneously stayed all further proceedings. No discovery or depositions of plaintiffs have been taken nor have plaintiffs been able to obtain any discovery of defendants. There is no factual record beyond the pleadings.

A unanimous Eleventh Circuit panel found that the prior opinion of the Fifth Circuit in *Shores* v. *Sklar*, 647 F.2d 462

(5th Cir. 1981) (*en banc*), *cert. denied*, 459 U.S. 1102 (1983) required the court to "recognize the fraud on the market theory as a basis for recovery where the defendant's deception inflates open market stock prices. To hold otherwise would result in this circuit adopting the theory in a setting where its applicability has been questioned, and rejecting its use where it best advances the goals of the federal securities laws." 734 F.2d at 745.

The panel also found, "independently" of binding Fifth Circuit precedent,[2] that the fraud on the market theory should be recognized. The court, quoting from *Blackie v. Barrack*, 524 F.2d 891, 906 (9th Cir. 1975), stated:

> We agree with the Ninth Circuit that:
>
> > causation is adequately established in the impersonal stock exchange context by proof of purchase and of the materiality of misrepresentations, without direct proof of reliance. Materiality circumstantially establishes the reliance of some market traders and hence the inflation in the stock price—when the purchase is made the causational chain between defendant's conduct and plaintiff's loss is sufficiently established to make out a prima facie case.

734 F.2d at 747. The court of appeals recognized that the fraud on the market theory does not eliminate the element of causation-in-fact. The theory provides that, where plaintiff alleges materiality and the purchase of securities in the open market, reliance may be presumed, "subject to the defendant proving that the misrepresentations were not material or that the plaintiff's decision to purchase

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[2] The Eleventh Circuit, in the *en banc* decision *Bonner* v. *City of Prichard*, 661 F.2d 1206, 1209 (11th Cir. 1981), adopted as precedent decisions of the Fifth Circuit rendered prior to October 1, 1981.

was or would have been unaffected if he had known the true facts." 734 F.2d at 748.

Thereafter, a suggestion of rehearing *en banc* was denied, with no member of the panel or circuit judge in active service having requested that the court be polled.

REASONS FOR DENYING THE WRIT

The Eleventh Circuit, following Fifth Circuit precedent, has done nothing more than affirm the application of the "fraud on the market" theory to its most appropriate instance—the traditional developed open market fraud case involving inflation of the market price of securities. In this context, the adequacy of pleading reliance on the integrity of the market has gained an overwhelming consensus in the federal courts. There is no dispute among the circuits, nor in the district courts, nor among the commentators. Petitioners do not contend otherwise. The Eleventh Circuit's opinion, affirming a well-established application of Rule 10b-5(1) and (3) to its paradigm case, does not raise any issue which warrants the attention of this Court.

The absence of any factual record, a consequence of the interlocutory nature of the appeal from denial of the motions to dismiss the Complaint, further militates against review.

There Is No Conflict With the Decisions of Other Circuits; There Is No Issue Which Needs to Be Settled by This Court

An overwhelming consensus has been reached among the federal judiciary and the commentators as to the question presented here, *i.e.* in what form causation/reliance need be pled in a securities fraud action complaint sufficient to withstand a motion to dismiss. When securities are publicly traded in a developed open market, the price of the securities reflects publicly available material information. It is therefore sufficient to plead reliance on the integrity of the market. This proposition has been termed "fraud on the market," *In re Memorex Security Cases*, 61 F.R.D. 88, 99 (N.D. Cal. 1973).

The sufficiency of pleading reliance on the integrity of the market in the stock exchange context has been explicitly or implicitly accepted by every circuit court of appeals to have discussed the question. *Blackie* v. *Barrack*, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976); *T.J. Raney & Sons, Inc.* v. *Fort Cobb, Oklahoma Irrigation Fuel Authority*, 717 F.2d 1330 (10th Cir. 1983), *cert. denied*, —— U.S. ——, 104 S.Ct. 1285, 79 L.Ed.2d 687 (1984); *Shores* v. *Sklar*, 647 F.2d 462 (5th Cir. 1981) (*en banc*), *cert. denied*, 459 U.S. 1102 (1983); *Ross* v. *A.H. Robins*, 607 F.2d 545, 553 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980); *Wachovia Bank & Trust* v. *Nat. Student Marketing*, 650 F.2d 342, 357 (D.C. Cir. 1980), *cert. denied*, 452 U.S. 954 (1981) ("Section 10(b) presumes reliance if . . . the misstatement affects the price of the stock").

In circuits that have not considered the adequacy of pleading "fraud on the market," district courts have accepted such pleading as sufficient. See (Third Circuit) *In re Ramada Inns Securities Litigation*, 550 F. Supp. 1127

(D. Del. 1982) and *Wolgin* v. *Magic Marker Corp.*, 82 F.R.D. 168 (E.D.Pa. 1979); (Fourth Circuit) *Frankel* v. *Wyllie & Thornhill*, 537 F. Supp. 730 (W.D. Va. 1982); (Seventh Circuit) *Grossman* v. *Waste Management*, 589 F. Supp. 395 (N.D. Ill. 1984) and *Mottoros* v. *Abrams*, 524 F. Supp. 254 (N.D. Ill. 1981); (Eighth Circuit) *In re McDonnell Douglas Corp. Securities Litigation*, 587 F. Supp. 625 (E.D. Mo. 1983) and *Dekro* v. *Stein*, 540 F. Supp. 406 (W.D. Mo. 1982). See generally the thorough discussion by Judge Higginbotham in *In re LTV Securities Litigation*, 88 F.R.D. 134 (N.D. Tex. 1980).

The fraud on the market theory advanced by the Eleventh Circuit in this case, giving plaintiffs a rebuttable presumption of reliance on the integrity of prices in the context of a developed market, has also been endorsed by the commentators.[3] For instance:

> A fraud on the market theory dispensing with a requirement that investors must actually read the disclosure documents is sound in the case of widely-traded securities. Affording plaintiff a presumption of reliance in the case of widely-traded securities follows logically from the efficient-market theory, and it is appropriate to transfer to the defendant the burden of disproving reliance.

Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Trans-*

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[3] Every commentator cited by petitioners supports the proposition here endorsed by the Eleventh Circuit. See also, Fischel, *Use of Modern Finance Theory In Securities Fraud Cases Involving Actively Traded Securities*, 38 Bus. Law. 1 (1982). The root notion that when a misstatement inflates values on the market and a buyer relies thereon, the buyer should be able to recover damages, was expressed by Professor Berle as early as 1931. Berle, *Liability for Stock Market Manipulation*, 31 Colum.L.Rev. 264, 269 (1931).

actions, 62 N.C.L. Rev. 435, 473 (1984). Similarly, Note, *The Fraud-on-The-Market Theory,* 95 Harv.L.Rev. 1143 (1982).

Significantly, two circuits that have not yet addressed "fraud on the market" have recently refused to accept 28 U.S.C. §1292(b) interlocutory appeals certified by district courts endorsing the theory. *Waste Management, Inc.* v. *Grossman,* Misc. No. 84-8048 (7th Cir. Oct. 4, 1984); *In re McDonnell Douglas Corp. Securities Litigation,* Misc. No. 84-8010 (8th Cir. Jan. 26, 1984). Evidently, neither circuit court of appeals found the question of law presented by petitioners to pose "substantial ground for difference of opinion" where resolution on appeal "may materially advance the ultimate termination of the litigation." 28 U.S.C. §1292(b).

It is thus clear that the opinion of the Eleventh Circuit falls within the sensible consensus view of the pleading requirements on reliance taken by the federal judiciary and the commentators: no issue requiring settlement by this Court is presented.[4] Indeed, no authority rejecting the fraud on the market theory as applied to developed markets has been cited by petitioners.

Petitioner in No. 84-646 (Peat, Marwick, Mitchell) views as the primary danger requiring review the supposed overbroad use of the efficient capital market hypothesis by "some" federal courts. Yet even the authority relied on by petitioner argues that the efficient capital market hypo-

[4] Petitioners rely on this Court's grant of certiorari in *Price Waterhouse* v. *Panzirer,* 458 U.S. 1105, *vacated as moot,* 459 U.S. 1027 (1982). However, the question presented and the procedural posture of that case were completely different. *Panzirer* v. *Wolf,* 663 F.2d 365 (2d Cir. 1981). Unlike the instant case, in *Panzirer,* there was a factual record regarding the circumstances of plaintiff's purchase, permitting review of the question of whether the chain of causation was too remote. This factual record was specifically referred to in the question presented.

thesis is acceptable where there is an active developed secondary market and the information at issue is publicly disclosed (therefore reducing costs of acquiring information to a minimum). See, Gilson and Kraakman, *The Mechanisms of Market Efficiency,* 70 Va. L. Rev. 549, 609-610 (1984). This is, of course, the case here.

Causation is not eliminated as defendants contend. As then District Judge Higginbotham stated in his oft cited opinion in *In re LTV Securities Litigation, supra,* 88 F.R.D. at 144:

> The fraud on the market theory does not eliminate the element of reliance but places it where in open market transactions it realistically belongs—connecting the purchaser to the market, not the specific misstatement.

The Eleventh Circuit opinion recognizes that, while reliance/causation may be presumed once materiality and market purchases are established under the fraud on the market theory, the presumption is "subject to the defendant proving that the misrepresentations were not material or that the plaintiff's decision to purchase was or would have been unaffected if he had known the true facts." 734 F.2d at 748. If the defendant can show no causation-in-fact, it would defeat recovery; the requirement of causation is preserved.

Petitioners' additional argument that the implied private right of action under §10(b) "nullifies" the remedy of §18, and that the legislative history of §18 "conflicts" with the pleading requirements as to reliance in §10(b) actions, opinion is simply wrong. Because Section 10(b) (unlike Section 18) imposes on a plaintiff the burden of proving *scienter,* the circuit courts have held these remedies to be cumulative. *Wachovia Bank & Trust* v. *Nat. Student Marketing, supra,*

650 F.2d at 354-359 and *Ross* v. *A.H. Robins, supra,* 607 F.2d at 551-556, cited in *Herman & MacLean* v. *Huddleston,* 459 U.S. 375, 103 S.Ct. 683, 689 n.21 (1983), for the proposition that "lower courts have continued to recognize that an implied cause of action under Section 10(b) can be brought regardless of whether express remedies are available."

The further argument that the "fundamental tort law of reliance", as traditionally defined in the action for deceit, has been "disregarded" ignores the holding of the court of appeals that the presumption of reliance on the integrity of the market can be rebutted. It also contravenes the teaching of this Court that "the anti-fraud provisions of the securities laws are not coextensive with common law doctrines of fraud. Indeed, an important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common law protections by establishing higher standards of conduct in the securities industry [footnote omitted]." *Herman & MacLean* v. *Huddleston, supra,* 103 S.Ct. at 691.

The final argument of petitioners is that somehow *Lipton* v. *Documation* creates a scheme of "investors' insurance." The substance of the argument is that because it may prove difficult for defendants to rebut the presumption of reliance on the integrity of the market, the causation requirement has been eliminated, and that the accounting profession will be liable for honest errors in judgment. Moreover, PMM contends that auditors who give professional certifications of financial statements for public dissemination are entitled to special consideration under the securities laws.

First, it should be emphasized that *audited* financial statement are normally heavily relied upon by public investors. Indeed, any significant change of an accountant's

audit opinion of an issuer's financial condition will directly affect the market prices of the issuer's securities. Thus, it can hardly be said that a public auditor, or audited financial statements, play a peripheral or tangential role in the integrity of the marketplace.

Second, the presumption of reliance in the developed market context presented here is quite appropriate as virtually every court has recognized. The causal connection is clear and direct. If a defendant can demonstrate the lack of materiality of the misrepresentation, or can prove that the security was purchased for reasons irrelevant to reliance on the integrity of the market, the presumption is rebutted. But this depends on the facts brought forward by the defendant. Petitioners apparently seek review of this "rebuttal" issue by reference to facts not in the record. See "Questions Presented," *supra*.

Finally, the purported threat of unlimited liability for investor losses in class actions is simply not present. The "fraud on the market" theory does not do away with the heavy burdens which a plaintiff still must overcome, *inter alia* proving *scienter*, materiality and damages. The question in this case is not liability for honest errors in judgment. Rather, the question is whether a plaintiff may recover when defendants, with wrongful intent, commit fraud upon open market investors.

The Decision Below Is Interlocutory; This Court Should Not Rule on the Fraud on the Market Theory and the Causation Element of Section 10(b) and Rule 10b-5 in the Absence of a Factual Record

The procedural posture of this case militates against granting review. Nearly four years have passed since the Complaint at issue was filed; no discovery has been had. The court below held sufficient the general allegations that plaintiffs relied on the integrity of the market in purchasing their Documation stock, which allegations give rise to a presumption that there is a sufficient causal connection to sustain a *prima facie* case.

Petitioners claim that plaintiffs have conceded the non-existence of any causal connection by admitting their unawareness of the documents in question or even "the auditors existence". There are no such facts in the record. Thus, they ask this Court to issue an advisory opinion on a hypothetical fact situation.

The facts concerning plaintiffs' reliance on the integrity of the market have not yet been adduced. Moreover, it is impossible to determine whether the legal questions which Petitioners seek to litigate will be dispositive.[5] If plaintiffs prevail after trial, this Court would have the benefit of a full record to assist it in analyzing the issues. This Court has long recognized the disadvantages inherent in review on interlocutory appeal. See, *United States* v. *Freuhauf*, 365 U.S. 146, 157-158 (1961); *Hamilton-Brown Shoe Co.* v. *Wolf Brothers*, 240 U.S. 251, 257-258 (1916); *American Construction Co.* v. *Jacksonville Ry.*, 148 U.S. 372, 384 (1893).

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[5] For example, plaintiffs have alleged an alternate theory of recovery under *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972). See ¶57 of the Complaint.

CONCLUSION

The petitions for a writ of certiorari should be denied.

Respectfully submitted,

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December 4, 1984

(4)

No. 84-646

IN THE

Supreme Court of the United States

OCTOBER TERM, 1984

PEAT, MARWICK, MITCHELL & CO.,

Petitioner,

—against—

DAVID A. and SYLVIA S. LIPTON,

Respondents.

REPLY BRIEF IN SUPPORT OF PETITION FOR CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

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9 pp

TABLE OF CONTENTS

TABLE OF AUTHORITIES

IN THE

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Respondents.

REPLY BRIEF IN SUPPORT OF PETITION FOR CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

Because of the procedural posture of this action, the allegations of the amended complaint are taken as true, and thus there are no issues of fact. Petitioner contends that as a matter of law the amended complaint fails to state a claim under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1982).

The Eleventh Circuit noted that respondents:

—"*did not rely* directly on [the allegedly] misleading documents"

(734 F.2d at 741 reproduced in Petitioner's Appendix at 2a, emphasis added). The district court similarly acknowledged:

—"There is *no allegation* that either plaintiff actually relied upon any supposed misrepresentations made by any defendant" (Appendix at 25a, emphasis added)

—"*plaintiffs concede* that their federal securities law claim is based on what has become known as the 'fraud on the market' theory." (Appendix at 24a, emphasis added).

Thus, respondents' pleading constitutes judicial admissions binding upon them. *See* 9 J. Wigmore, *Wigmore on Evidence* § 2588 *et seq.* (Chadbourn rev. 1981).*

The pleading at issue here makes this case very different from that "normally" presented where it is alleged "that audited financial statements . . . [were] heavily relied upon by public investors" (Respondents' Brief at 11). *See United States* v. *Arthur Young & Co.*, 104 S.Ct. 1495, 1503 n.14 (1984).

The order below has the effect of providing a damage remedy to a class of persons who never read or relied upon the auditor's report and it encourages reckless market transactions and the very type of vexatious litigation found objectionable by the Court in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 739 (1975) ("[t]here has been widespread recognition that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general").

The question presented raises exactly the issues of *Panzirer* v. *Wolf*, 663 F.2d 365 (2d Cir. 1981), *cert. granted sub. nom. Price Waterhouse* v. *Panzirer*, 458 U.S. 1105, *vacated as moot*, 459 U.S. 1027 (1982). *See* Petition for Certiorari filed in *Panzirer* (No. 81-1998) on April 28, 1982. They remain as important now two years later as when the Court granted

* Respondents' effort in opposition to the Petition to create a factual dispute for the first time has no colorable support.

certiorari to consider them but was denied the opportunity because of mootness.*

Since approximately one-third of all cases, public and private, brought under the federal securities statutes are 10b-5 actions, *see* 1 A. Bromberg & L. Lowenfels, *Securities Fraud and Commodities Fraud* § 2.5(6) (1983), it is imperative that the Court give guidance as to the contours of the causation/reliance element of the judicially created 10b-5 remedy. *See Blue Chip Stamps* v. *Manor Drug Stores*, *supra*, 421 U.S. at 737.

The potential breadth of the rule announced by the court of appeals cannot be overestimated. Statements that include information, rumor, advice, opinion and crystal ball gazing about publicly-traded companies are extremely widespread. They appear as news stories in the daily press; as articles ranging from topical events to "think pieces" in weekly publications of general orientation (*e.g.*, *Time*, *Newsweek*) and business orientation (*e.g.*, *Business Week*, *Barron's*); as spe-

* In *Panzirer*, respondent unsucessfully opposed the petition, raising alleged disputes of "fact." *See* Brief in Opposition (No. 81-1998) filed May 27, 1982). *Panzirer* arose out of a contested motion for summary judgment and thus was in an analogous procedural posture. Because of the purity of the legal issues presented in a Fed.R.Civ.P. 12(b)(6) context, the Court has often granted certiorari in the procedural posture presented here. *See, e.g., Transamerica Mortgage Advisors, Inc.* v. *Lewis*, 444 U.S. 11 (1979); *Touche Ross & Co.* v. *Redington*, 442 U.S. 560 (1979); *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462 (1977); *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976); *United Housing Foundation* v. *Forman*, 421 U.S. 837 (1975); *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975). As stated in R. Stern & E. Gressman, *Supreme Court Practice* (5th ed. 1978):

> "where . . . there is some important and clear-cut issue of law that is fundamental to the further conduct of the case and that would otherwise qualify as a basis for certiorari, the case may be reviewed despite its interlocutory status." (*Id.*, § 4.19 at 301.)
>
> * * *
>
> "As long as the jurisdiction of the court of appeals has properly been invoked and a timely petition for certiorari filed, the Supreme Court has jurisdiction to take the case whatever its status in the lower courts. *The Conqueror*, 166 U.S. 110, 113." (*Id.*, § 2.2 at 53.)

cialized, paid-subscription services (*e.g.*, *Value Line Survey*); as investment letters or reports on in-house research by brokerage houses and investment advisors; and as tips, rumors and speculation circulating within the investment community. They are heard regularly on radio and television (*e.g.*, *Wall Street Week*).

Any such statement, opinion, rumor or tip can induce investment decisions. Many are expressly designed to do so. Under the holding below, auditors are faced with extensive discovery, trial and possible civil liability arising from every investment decision if the plaintiff merely alleges that his investment was preceded—and thus by hypothesis was influenced in some way—by misleading financial statements or the auditor's opinion thereon that the plaintiff has never seen or heard. The decision below would permit a 10b-5 action to be maintained upon the mere coincidence in time between the allegedly misleading financial statements and market gossip that persuades an investor to purchase.

The court of appeals relied on the Court's decision in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972). In their opposition to the Petition so do Respondents. (*See* Respondents' Brief at 13n). That decision, however, involved silence in the context of face-to-face transactions giving rise to an affirmative duty to disclose. *Affiliated Ute* does not justify, and certainly does not compel, the rule announced below.

In *Affiliated Ute*, two bank employees, acting in a fiduciary capacity on behalf of the sellers and also as purchasers and market-makers for the securities in question, fraudulently failed to inform the sellers, in face-to-face transactions, (a) that the bank employees stood to gain from the transactions and (b) that a higher price for the securities could be obtained by selling on another market. 406 U.S. at 153. In *Chiarella* v. *United States*, 445 U.S. 222, 229-30 (1980), the Court characterized *Affiliated Ute* as involving silence—refraining from making any statement—in the context of an affirmative duty

to speak arising out of a fiduciary relationship of trust and confidence.

In the factual pattern and legal context of *Affiliated Ute*, the Court stated that when a 10b-5 claim involved silence, "positive proof of reliance is not a prerequisite to recovery" if materiality to the investor can be established. 406 U.S. at 153-54. It distorts *Affiliated Ute* beyond recognition to hold, as did the court below, that under *Affiliated Ute* an auditor who has issued an opinion on an issuer's financial statements is liable to a securities purchaser who never sees, reads or hears about the opinion or the financial statements and who has no business or fiduciary relationship with the auditor.

The legislative history of the Securities Exchange Act of 1934 does not permit the liberty taken by the court below. *See* Petition at pp. 8-10. And the lower courts and the commentators are by no means consistent in the adoption or interpretation of the efficient capital market hypothesis or market fraud theory.

Because of the "special function" of the independent auditor in our society, *United States* v. *Arthur Young & Co.*, 104 S.Ct. 1495, 1503 (1984), review of the decision below is particularly important.* The question presented, drawn entirely from the amended complaint, raises fundamental and clear-cut issues of law which impact upon this and many other cases.

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* Respondents are simply incorrect that this argument is a new one. (*See* Respondents' Brief at i). It bears repeating that in their amended complaint respondents distinguish between the company and its management on the one hand and the independent auditor on the other. *See* Petition at pp. 4-5 & n.1.

CONCLUSION

The petition for a writ of certiorari should be granted.

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